EB-2014-0105

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 an Application by Ottawa River Power Corporation pursuant to the *Ontario Energy Board Act* for an Order or Orders approving rates for the distribution of electricity commencing May 1, 2016

FINAL ARGUMENT
OF THE
SCHOOL ENERGY COALITION

April 3, 2016

JAY SHEPHERD PROFESSIONAL CORP.
2200 Yonge Street, Suite 1302
Toronto, Ontario M4S 2C6

Jay Shepherd

Tel: 416-483-3300
Fax: 416-483-3305
jay.shepherd@canadianenergylawyers.com

Counsel for the School Energy Coalition

1 INTRODUCTION AND SUMMARY

1.1.1 On October 5, 2015 the Applicant Ottawa River Power Corporation filed an Application to set just and reasonable rates for the distribution of electricity for the period commencing May 1, 2016. All issues except one have been settled, and a Settlement Proposal has been filed with the Board.

1.1.2 The remaining issue is the interest rate to be applied to the Applicant's deemed debt, all of which is owed to its shareholders, four municipalities. The Applicant proposes a rate of 7.25%. The other parties propose a rate equal to current market rate, but in any case no more than the Board's current deemed rate of 4.54%.

1.1.3 Oral evidence was heard on March 31, 2016, and both Argument in Chief and OEB Staff Argument were heard orally at that time. This is the final argument of the School Energy Coalition on the one unsettled issue.

1.1.4 SEC submits that, on the basis of the evidence before the Board, the debtholders, who were also the shareholders, did not make a binding and enforceable commitment that the interest rate would not exceed 7.25% for 20 years. As a result, they are not entitled to rely on the Board's cost of capital policy to continue to charge an interest rate that is well above market, and which is not reasonable. The maximum rate they should be allowed to include in revenue requirement, and recover from ratepayers, is 4.54%.

1.1.5 This final argument has six parts:

(a) Impact.

(b) What happened to the notes that were supposed to be prepared in 2000?

(c) What were the terms of the debt?

(d) Response to each of the arguments of the Applicant.

(e) Reasons the Board should deny above market interest rate.

(f) Conclusion.

2 IMPACT

2.1.1 This is a small utility, and it is in fact rare that a Board panel is forced to adjudicate issues that have a dollar impact as small as is presented in the unsettled issue. However, for the approximately 10,800 ratepayers served by the Applicant, this is an important issue, and it certainly is important to the Applicant and its shareholders.

2.1.2 The difference between interest at the requested rate, and at market rate, is about a million dollars over the five year IRM period[1]. That works out to a rate increase for the Applicant's customers of 6.73% in 2016[2], instead of 12.05% as proposed by the Applicant. If the Board's deemed rate of 4.54% is applied to the debt, the rate increase would be 7.62%[3].

2.1.3 On average, the impact of this rate differential is about $100 per customer, but for some it is more. For example, for the 18 schools in the Applicant's service territory, it is about $1200 each.

2.1.4 For the Applicant, losing $1 million of revenues would be a material amount[4]. However, as is noted below, under the terms of the debt it is not the Applicant that would bear the cost. The Board's decision on the interest rate will reduce the amount recovered from the ratepayers, but it will also reduce, dollar for dollar, the amount to be paid to the municipalities. The evidence is that the municipalities will have to increase their property taxes by 1% to make up the difference[5].

3 WHAT HAPPENED TO THE NOTES?

3.1.1 This matter comes before the Board in part because the Applicant is not able to produce the promissory notes on which it relies to claim the interest cost. SEC emphasizes that lack of the promissory notes does not imply lack of a debt. There is no dispute in this proceeding as to whether the Applicant owes money to its four shareholder utilities, nor the amount that is owed. It is common ground between the parties that the amount owing is $5,585,538[6], and that it is a binding and enforceable debt obligation.

3.1.2 The Applicant has consistently alleged that the debt is evidenced by promissory notes, and has done so in its evidence before the Board in this proceeding[7], in EB-2009-0165, and in EB-2005-0403. However, at no time has the Applicant provided contemporaneous, documentary, or sworn evidence that the said notes actually existed. At best, and despite the Applicant's counsel repeating several times that the notes existed[8], the Board actually has evidence only that people believe they may have existed.

3.1.3 The known evidence is not consistent with the notes ever existing. As the Applicant

[1] Tr.:39.
[2] Assuming a market rate of 4%.
[3] Tr.:38-40.
[4] Tr.:40.
[5] Tr.:86.
[6] K3, p. 2.
[7] Ex. 5; Tr.:37.
[8] By way of example only, Tr.:113, multiple times.

admits, some ten to fifteen people would have had copies of the notes, had they existed[9]. There was no common event that would have caused all of them to lose their copies. They would have been held and stored in different places, including in the offices of law and accounting firms that have legal obligations to preserve client documents in their possession.

3.1.4 Notwithstanding this, the evidence is that everyone who should have had a copy has looked for it, and no-one has been able to find their copy, nor any of the originals[10].

3.1.5 The inability of the Applicant to present to the Board the promissory notes on which it relies can only be explained one of two ways:

(a) Ten to fifteen people, some of whom had legal obligations to preserve the documents, lost them despite no common cause for such loss.

(b) The promissory notes were never prepared in the first place.

3.1.6 SEC submits that the first conclusion is not a reasonable one. The probability that so many people would simultaneously lose important documents is negligible. Therefore, it is submitted that the Board should conclude the promissory notes were never prepared.

3.1.7 This is supported by the evidence, in two ways.

3.1.8 First, the evidence shows that at least some people involved thought the attachment to the by-law was in fact the evidence of the indebtedness (i.e. the "note")[11].

3.1.9 Second, Mr. Scott, who was Mayor of Pembroke at the time, was frank in his assessment that it is quite possible the notes were simply never prepared, saying[12]:

> *"MR. SHEPHERD: So here is what I'm concerned with. The idea that ten or fifteen people would have had a copy or original of these notes and they've all disappeared doesn't strike me as logical.*
> *And I guess I'm wondering whether the better explanation – and I'm asking you to tell me whether the better explanation is that promissory notes were simply not prepared at the time. Is that reasonable?*
> *MR. SCOTT: I think there was a gap in follow-through. There were changes in the people that were involved, there were political changes, and <u>I would think it might be fair to say that they just were not done, yes</u>."[emphasis added]*

[9] Tr.:47.
[10] Tr.:44.
[11] Tr.:30.
[12] Tr.:47. See also, Tr.:41; 79.

3.1.10 SEC therefore submits that there were no original notes. There was a debt owing, but there were no promissory notes evidencing that debt. They were intended, perhaps, but they were simply never prepared.

4 WHAT WERE THE ACTUAL TERMS OF THE DEBT?

4.1.1 The lack of a promissory note does not mean there is no debt. Most debts, in fact, are not evidenced by a promissory note[13]. Where that is the case, it is necessary to look to the evidence to determine what was agreed between the debtor and the creditor.

4.1.2 ***The "Replacement" Notes.*** It is surprising, perhaps, that the Applicant would file in evidence documents, prepared by their regulatory counsel[14], purporting to be replacements of notes that, on the evidence, probably never existed in the first place. It is even more surprising that those so-called "replacement" notes would be on terms not found anywhere in the contractual documents. The terms, instead, specifically track the Board's Cost of Capital policy, which of course did not exist in 2000, when the debt was incurred.

4.1.3 It is not surprising that the municipalities, realizing that their utility's debt to them was not evidenced by promissory notes, would seek to have notes prepared. Once a lender identifies that they are missing a note, the logical response is to fix the problem. That response, however, would normally be to go to the lender's normal corporate counsel, or to the lawyer who prepared the document originally, and ask them to replicate the original document based on the extant documents relating to the transaction. Alternatively, if that is not possible or preferred, the response could be to create new notes, reflecting an agreement today on the new terms going forward. Either response would get the job done.

4.1.4 What you would not normally expect is that the lender would by-pass their normal counsel, go instead to specialized regulatory counsel, and then give them no specific instructions on what to include in the new notes[15].

4.1.5 The new notes prepared by counsel for the Applicant establish, for the first time, a purported obligation that the interest rate on the debt will not exceed a specific rate. This is, of course, one of the two primary Board requirements for a utility that wants to pay its shareholder an interest rate in excess of market rates.

4.1.6 In Argument in Chief, counsel for the Applicant alleges that the "replacement" notes

[13] Many day to day commercial transactions involve one person owing something to someone else. That is a debt, but there is no promissory note. Even cash loans are often not evidenced by a promissory note. That is usually limited to formal lending and borrowing transactions.
[14] Tr.:48.
[15] Tr.:49-50.

are evidence of the original terms of the debt[16]. They are not. They are merely argument, essentially submissions on behalf of the Applicant as to what they would like the Board to conclude[17].

4.1.7 ***The Transfer By-law.*** The initial evidence of the terms of the debt is in Schedule G to the transfer by-law, which essentially operates like an agreement of purchase and sale. Schedule G to the Transfer By-Law provides as follows[18]:

> *"Such Promissory Note to be due and payable on the 1st day of January, 2002, to be non-interest-bearing from January 1, 2000 to market opening, which is currently slated for November 7, 2000, and thereafter, to bear interest at an effective rate, currently 7.25% per annum, term and interest to be renegotiated annually."[emphasis added]*

4.1.8 Thus, there was no cap on the interest rate, nor was it fixed for any period. In fact, the parties clearly intended that it would change[19].

4.1.9 ***Original Shareholders Agreement***. Also attached to the Transfer By-law was the original shareholders agreement. The interest rate on the debt was described in that document as follows[20]:

> *"The parties further agree that the Corporation shall pay interest on the Promissory Notes to Beachburg and to Pembroke on the respective Notes in an amount not to exceed the maximum interest allowed by the Ontario Energy Board, based upon their Handbook or any other regulation, schedule or document to be prepared or enacted by them…*
>
> *The parties hereto agree that they may adjust the interest rate on the said Promissory Notes at the times and in the manner as set out by regulation, and in an amount not to exceed the maximum interest rate allowed by any schedule, statute or otherwise as enacted by the Ontario Energy Board…"[emphasis added]*

4.1.10 The original shareholders agreement is evidence that there was no fixed 7.25% rate, because that rate is not referenced in the document at all. Further, the shareholders

---

[16] Tr.:53. Counsel for the Applicant says "…we've provided copies of affidavits of loss as well as copies of replacement notes, which all the parties to those notes agreed were consistent with the terms of the original promissory notes." Unfortunately, there is no evidence on the record to support the statement that all parties agreed to those terms of the notes. The evidence on the record, in fact, appears to contradict that statement.
[17] Alternatively, they are evidence of the parties' current agreement with respect to the terms of the debt, in which case the Board's current deemed rate would apply. There is no situation in which they are evidence of the parties agreement in 2000 with respect to the debt.
[18] K3, p. 19.
[19] We note that the Applicant proposes that the word "currently" before the 7.25% be ignored (treat it as fixed instead), while admitting that the same word, denoting market opening, expressed the variability of the date.
[20] K3, p. 22-23.

agreement is direct evidence that there is no cap on the interest rate, because in fact the parties to the shareholders agreement agree that it may be adjusted, as long as it doesn't exceed the Board's maximum allowable.

4.1.11 The Applicant will, of course, argue that the Applicant could simply refuse to agree to any rate increase, and thus protect itself[21]. That is not the law, nor is it the practical reality in this situation. This is a unanimous shareholders agreement. Under the Ontario Business Corporations Act, management of a corporation is not free to act contrary to the provisions of a unanimous shareholders agreement. In addition, as a practical matter the shareholders control the board of directors, and can cause an amendment to the interest rate to occur. The witnesses admitted this[22].

4.1.12 It is therefore clear that, in the shareholders agreement, there is neither a cap on the interest rate, nor a fixed interest rate, and there is express agreement that the interest rate can change.

4.1.13 ***Current Shareholders Agreement***. With the addition of Killaloe et al and Mississippi Mills, the shareholders agreement was replaced on October 1, 2000. However, the terms noted above were carried through, verbatim, to sections 13(e) and (f) of the new agreement. The new agreement did specify that the debt would be due and payable twenty years after market opening. It did not say whether the shareholder/debtholders could call the debt on demand, although of course they were free to do so in practice, as they controlled the Applicant.

4.1.14 The conclusions above are therefore unchanged. There is no fixed rate, and there is no cap on the rate. It is to be amended in the future. That was the deal.

5 ARGUMENTS OF THE APPLICANT

5.1.1 Faced with the evidence, what are the arguments of the Applicant in favour of the 7.25% rate?

5.1.2 ***The Debt was Embedded, Non-Callable Debt at a Fixed Interest Rate***[23]. The Applicant argues that the Board's cost of capital policy (EB-2009-0084) should apply because this debt was non-callable, and had a fixed interest rate.

5.1.3 Neither assertion is supported by the evidence.

5.1.4 Is the debt callable? There is no evidence for or against that. The evidence is completely silent on the point. What the Board knows is that the shareholders can cause the debt to be repaid at any time, because they own 100% of the shares of the

---

[21] Tr.:114.
[22] Tr.:56; 76.
[23] Tr.:107.

Applicant.

5.1.5 Is the rate of 7.25% fixed? The Applicant in fact admits that there is no reference in any of the evidence to the rate being fixed[24]. In the only operative document that even mentions that rate, it says "currently 7.25%", which clearly implies that it is going to change[25]. There are also express agreements that the rate can be changed.

5.1.6 The Applicant argues that the term of the transfer by-law – "to be renegotiated annually" – is an agreement to agree, and is thus not enforceable[26].

5.1.7 With respect, that is not the law. There is no agreement to agree. There is an agreement to negotiate, and as a matter of Canadian law if the intention of the parties is to negotiate, and it is expressed in a binding way, the parties are obligated to negotiate. Failure to do so is a breach of the contract[27].

5.1.8 What the Applicant is proposing, instead, is that the Board ignore the express statements of the parties that they will work out the interest rate in the future, initially annually, and then in the shareholders agreement at unspecified times. This is not a credible argument.

5.1.9 Underneath this, though, is a failure of the Applicant to address the rationale behind the Board's policy.

5.1.10 The Board says, quite reasonably, that utilities should not be able to pay above-market interest to their affiliates, and then recover that money from the ratepayers. There is an exception, however. The exception is where, as part of a prudent commercial bargain, the utility gets protection from future interest rate increases, in return for agreeing to a fixed rate. It is a quid pro quo.

5.1.11 That is not the case here. The Applicant had no protection against rising interest rates. In fact, the shareholder/debtholders made very sure to put in the shareholders agreement (so that it would be binding on the Applicant) that the rate could be changed, as long as it did not exceed the OEB maximum rate. They also made sure not to include in the shareholders agreement any reference to 7.25%.

5.1.12 Far from the Applicant having protection, the Applicant was expressly at risk. It would have to continue to pay 7.25%, unless the shareholders demanded more.

5.1.13 SEC therefore submits that the Board's Cost of Capital policy exception does not apply to this debt.

---

[24] Tr.: 57; 60; 63, and most clearly, 68.
[25] Tr.:56; 64.
[26] Tr.:114; 118.
[27] This stands to reason. Otherwise, why would people so often put clauses in agreements stating that they will agree to a particular point at some time in the future?

5.1.14 ***The Board has Approved This Rate Before, on the Same Evidence[28]***. Counsel for the Applicant says:

> *"This means that the Board has heard evidence on these notes in the past and, based on that evidence, it has shown in this decision, has previously approved the use of a 7.25 percent interest rate.*
>
> *In this decision the Board expressly noted evidence of, one, the notes having a fixed term of 20 years and are not callable; and two, the 7.25 percent interest rate is identical to the Board's deemed rate at the time the notes were issued.*
>
> *When I went back and looked at the evidentiary record in EB-2009-0165, I wanted to see exactly upon what evidence the Board panel made that decision. And what I can confirm for you today is that the Board panel made its decision based on the same evidence that is currently included in Exhibit 5 of the rate application that you have before you today. The exact same evidence."*

5.1.15 To say that "the Board has heard evidence on these notes" is, at best, only technically correct. The Board was told by the Applicant in EB-2009-0165, that non-callable promissory notes at a fixed interest rate of 7.25%, dated in 2000, actually existed. The Board never saw those notes (probably because they didn't actually exist), and the facts underlying the interest claim were never tested[29]. Everyone believed the Applicant, and no-one asked to look at the promissory notes[30].

5.1.16 It turns out that there were no promissory notes, and there was no other evidence that the debt was fixed rate and non-callable. The Board therefore did not have the correct facts, and the conclusion the Board (and the parties) reached in that case cannot be relied on today.

5.1.17 ***The Applicant has Paid 7.25% for the Last 15 Years***. The Applicant tries to characterize this as evidence of the intention of the parties[31]. It is not. It is evidence that the municipalities wanted to continue to get their high rate of interest, especially since interest rates were lower, and the Applicant complied with its owners' requirements.

5.1.18 This can be contrasted with the situation if interest rates had ballooned to 20%, as they did in the distant past, but the municipalities kept their rate at 7.25%. If that had happened, the argument that the parties' actions are evidence of intent would be useful, because the relevant intent – protection against increases in rates – would be

[28] Tr.109-110.
[29] Tr.:122.
[30] VECC made no submissions on cost of capital, accepting the utility's evidence. OEB Staff noted the assertions of the Applicant, and stated that based on those assertions the interest rate was consistent with the Board's policy.
[31] Tr.:117.

demonstrated.

5.1.19 Instead, what we have here is a pattern of behaviour in which the shareholder/debtholders received $2-3 million dollars of above-market interest over the last fourteen years, and now are alleging that fact – far from being a bad thing - actually <u>entitles</u> them to another million dollars of above market interest over the next five years.

5.1.20 SEC submits that the past payment of the 7.25% rate is evidence only of the fact that the Applicant has consistently overpaid for the debt it owes to its shareholders[32].

5.1.21 ***The Municipalities Need the Money.*** Counsel for the Applicant, to his credit, did not make this argument, but it was implicit in the evidence. If the Board doesn't allow the Applicant to continue to overpay on interest, the municipalities will be short of money. The Board did hear this argument from the Chairman of the Board of the Applicant.

5.1.22 This devolves into an argument that a utility can pay any amounts it wants to their shareholders, whether as interest or anything else, because the shareholders are municipalities and use the money in ways that benefit the public.

5.1.23 This is not a credible argument. It would imply that the Board should not set any limits on payments to municipal shareholders. That can't be right.

5.1.24 ***The Interest Rate Was Trade-Off for a Below-Market Lease.*** Again, counsel for the Application did not make this argument, but it was raised in evidence. This is not a credible argument, for two reasons.

5.1.25 First, the central argument of the Applicant is that the interest rate was reasonable at the time the debt was incurred. If that were true, as it probably was, then there was nothing to trade off. The Applicant was not paying above market interest at the outset, so there was no excess to compensate the municipalities for their allegedly low lease rate.

5.1.26 Second, the evidence is that Pembroke was at that time in economic trouble, with businesses closing, and there was ample commercial space available[33]. The city entered into a triple-net lease with the Applicant at nominal fixed rent. This benefitted the city in two ways. The expenses of the building, including the landlord's costs, were all paid by the Applicant, including maintenance, insurance, security, improvements. Some or all of those would have to be paid by the city if the Applicant located in a different building[34]. As well, the Applicant was responsible to pay property taxes on the building, which would be lost to the city without a tenant like the

[32] In this respect, we agree with OEB Staff, at Tr.:126.
[33] Tr.:96.
[34] Tr.:99.

utility[35].

5.1.27 In SEC's submission, for these two reasons the attempt to tie together the interest rate and the lease should be ignored[36].

5.1.28 ***The Municipalities Have Deferred to the Board[37].*** There is one argument of the Applicant with which we can agree. The Applicant argues:

> *"What the municipalities have done in their shareholder agreement is basically defer judgment to you, the Ontario Energy Board, to decide what is best and what's in the public interest. They've set a cap, a maximum rate, which says it's what you guys say it is, based on your handbook, which was what was available at the time, but also any regulation, schedule, or other document that you prepare."*

5.1.29 SEC agrees; this is exactly what the Applicant and its shareholders have done. The Board sets just and reasonable rates, and whatever the just and reasonable interest rate, that is what should be paid. That rate is not 7.25%.

6 ARGUMENTS OF THE RATEPAYERS

6.1.1 ***The Applicant Wants Permission to Pay Above-Market Interest.*** The argument from the point of view of the ratepayers starts with the recognition that the Applicant is seeking permission to pay above-market interest to its shareholder/debtholders, and to recover that interest from ratepayers. In normal circumstances, this would not be allowed, as it would be contrary to the statute that requires rates be "just and reasonable". The law is clear that utilities under cost of service are allowed to recover their prudently incurred costs of providing distribution services, but not more than that. Paying interest above market rates is prima facie imprudent. The Board has gone to a lot of trouble to have an express policy dealing with this, and is vigilant in ensuring that ratepayers are not disadvantaged by the terms of affiliate debt.

6.1.2 The Board does have an exception, however, in which the Board believes that it is prudent to pay above-market interest rates. That exception relies on the commercial reality that protection from increasing interest rates is valuable to the utility and its ratepayers. When you get that protection, and the value that comes with it, you have to pay for it, either in dollars, or by accepting an offsetting risk.

6.1.3 In this case, the policy the Applicant seeks to invoke says that the utility can give up its ability to pay lower interest rates, if at the same time it receives protection against higher interest rates. To invoke this, the Applicant must show two things: a) the

---

[35] Tr.:99.
[36] We note that the Mayor at the time, Mr. Scott, admits that such a tradeoff was never discussed. Tr.:83.
[37] Tr.:119.

interest rate could not be increased, and b) the debt could not be called.

6.1.4 In all other cases, the rate the Applicant can recover from its customers can be no more than current market rates, which the Board determines, in the absence of any specific evidence, to be a deemed rate, now 4.54%.

6.1.5 ***Onus On the Applicant.*** The onus to prove these facts is on the Applicant, as they rightly admit[38].

6.1.6 They have failed to do so. There is, in fact, no evidence before the Board that:

(a) The 7.25% interest rate was either fixed, or a maximum.

(b) The shareholder/debtholders could not call their debt prior to 20 years if they wanted the money sooner.

6.1.7 In fact, the evidence that does exist shows that the interest was intended to change when the maximums set by the Board changed, and in any case was to be renegotiated annually. That never happened, presumably because the municipalities were getting a windfall from the existing 7.25%, and didn't want to lose it.

6.1.8 ***Management and Directors of the Applicant were Imprudent.*** While it is understandable that the Applicant could not force its shareholders to take a lesser interest rate, their failure to even look at the possibility was, it is submitted, contrary to their obligations to the ratepayers, and contrary to their fiduciary obligations to the company.

6.1.9 The evidence is that the Applicant was not even aware that the Promissory Notes were lost, or did not exist, until the ADR in this proceeding[39]. The obligation of management, and the obligation of the board of directors, was to be proactive in seeking ways to reduce distribution costs[40]. They were aware that they were paying interest well above market rates, and the difference was material to the utility and its ratepayers. Faced with those facts, neither management nor the directors even asked the question: Is there any way we can bring this down to market rates?[41]

6.1.10 We note that, had they done so, they would have had to look at the notes, and would have discovered they were missing. It is speculation, of course, but it is at least possible that, in those circumstances, a new deal would have been struck on more

[38] Tr.:109. The attempt by counsel for the Applicant, at Tr.:101, to reverse that onus is not helpful. The Applicant has to prove a fixed rate. The ratepayers do not have to prove a variable rate. The Applicant is asking for special treatment under an exception to the normal rules.
[39] Tr.:70, 71.
[40] Yes, their obligation is to comply with their contractual obligations, as noted by counsel for the Applicant: Tr.:121. However, first they have to actually look at the contract and determine what those obligations are.
[41] Tr.:59.

favourable terms.

6.1.11 In our submission, management and board of directors had at least the obligation to investigate, and try to reduce an unreasonable interest rate.

7 CONCLUSION

7.1.1 SEC therefore submits that the Board should include in revenue requirement, and allow the Applicant to recover in rates, interest on the deemed debt at no more than the current deemed rate, 4.54%.

7.1.2 The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible

All of which is respectfully submitted.

____

Jay Shepherd
Counsel for the School Energy Coalition