

The Electricity Distributors Association's (EDA) comments below respond to the Ontario Energy Board's (OEB) Draft Report of the Board: Corporate Governance Guidance for OEB Rate-Regulated Utilities dated March 28, 2018 EB-2014-0255 (the Draft Report) and are structured as:

- General comments;
- Comments on topics identified by the OEB; and
- Concluding Comments.

1) General Comments

Corporate governance is implemented through structures, processes and behaviours that direct and control the organization, manage executive decision making and improve performance. Good corporate governance can be achieved through a range of practices and a variety of structures and processes. Their efficacy cannot be demonstrated or tested for using a rules-based approach.

LDCs adhere to and value good governance practices and actively evolve their governance posture and structures to improve and strengthen them. This is the background against which the EDA is responding to the Draft Report.

Whether the Proposed Solution is Appropriate for the "Problem"

We believe that the OEB has not clearly articulated either the driver of, or the need for, this initiative. While the OEB has referred in general terms to alignment of interests, customer interests, investment discipline, etc., it has not communicated whether this initiative is focused on dealing with an existing industry-wide problem, dealing with outliers or pre-empting a future problem. For these reasons the EDA and its members have difficulty in assessing whether the OEB's proposed 'one-size-fits-all' approach to the provision of good governance is appropriate. Improved articulation by the OEB of the purpose and targets of the Draft Report would assist the EDA in its evaluation.

Recognition of the Role of the Shareholder

Utilities are firms that provide public goods at commercial terms and conditions. LDCs in Ontario are natural monopolies and are subject to economic regulation; Ontario's LDCs are subject to the OEB's oversight and powers.

Shareholders, by definition, own the corporation. Shareholders bear risks, specific to their investment in the corporation, and must have tools to manage that risk, even in a regulated context. Shareholders nominate directors to supervise the activities of the firm they have invested in. The shareholders of the corporation are uniquely empowered to elect the Board of Directors to govern the corporation. Ontario's municipalities were required under the *Electricity Act* to transfer their electricity distribution assets to corporations created under the *Ontario Business Corporations Act*. That legislation provides corporations with broad flexibility on appropriate governance structures. Further, it specifically enables Shareholder Agreements that provide shareholders with tools to implement parameters of governance (e.g., that avoid

conflicts, set high level priorities, set out the division of roles) that are suitable to their specific circumstances. Ontario's municipally owned utilities are unique in that the shareholder has a unique and ongoing relationship with rate payers such that the shareholder is motivated to act in rate payers' interests.

It is important to distinguish the risks of the shareholder from the risks of the utility. In tangible terms, the shareholder's investment risk due to its ownership of the LDC is separate and distinct from the business and financial risks that the LDC incurs and manages. This distinction is particularly relevant to Board members who may have been elected by the Shareholder as they are obliged to fulfill a duty of care (care, diligence and skill meeting a certain legal standard) and a fiduciary duty to act honestly and in good faith, with a view to the best interests of the corporation and can bear personal liability for non-performance.

Consequently, given that the fiduciary duty and duty of care to the entity applies to any Director, the EDA advocates that the proposed guidance on governance should recognize that discharge of these duties includes taking into account and balancing the legitimate interests of the customers, the Company's owners, and other stakeholders. A guideline that provides an undue influence on a specific stakeholder group risks outcomes that are not conducive to acting in the interest of the corporation.

Flexible and Adaptable Governance: Not "One Size Fits All"

LDCs recognize that the professionalism of their directors contributes to good governance that addresses the long-term sustainability of the corporation and impacts all stakeholders (e.g., by appropriately incorporating stakeholder interests, including those of shareholders). Ontario's electricity distributors have developed and tailored their governance structure and practices for the needs of the business, the interests of the communities they serve and the stakeholders they engage. They adhere to good governance practices and actively evolve them. LDCs are expected to excel in utility performance which is predicated on good governance and the structure and resourcing of their governing bodies. Their provision of good governance is premised on a flexible structure that is purpose-driven and suited to the reality of the business and the ownership structure.

The EDA notes that its members strive for diversity at all levels, including at the Board level. This is an emerging criterion that is becoming more relevant in today's rapidly changing regulatory environment and in many aspects of day-to-day life. It should be a factor considered when assessing good governance.

LDCs, the EDA and the IESO are all aware of, and actively engage in, leading and managing change. The EDA's recently released paper, *"The Power to Connect: A Roadmap to a Brighter Ontario"*, addresses technological change explicitly. The EDA acknowledges that LDCs' governance structures must be flexible to adapt to future market and policy evolution, so that LDCs are equipped to appropriately participate in all market sectors and not to bear inappropriate burdens or perhaps incur barriers as technology and the sector evolve.

Factors Rather than Checklists

The EDA suggests that a check list, in isolation, is an inappropriate tool to evaluate the quality of governance. The EDA's members expressed that it is advantageous to assess good governance using a holistic matrix that incorporates the data the OEB seeks (e.g., number of directors, independence, skills

and experiences) and provides context. For example, a matrix could display the proportion of Directors who are not independent, their skills and experiences, the Committees they sit on, and their voting rights at the Committee level and the Board level.

Use of Reporting and Record Keeping Requirements

The EDA notes that the OEB is providing governance guidance to all rate regulated entities and, in an unprecedented step, is proposing mandatory Reporting and Record Keeping Requirements (RRR) with respect to its guidance. It is logically inconsistent to have mandatory reporting on the adoption of guidance.

The EDA was challenged to understand the OEB's assertion that governance will be a factor that informs the standard of regulation provided by the OEB. If the OEB intends to leverage governance data in this manner, then Ontario's LDCs request that the OEB be transparent about the decision-making process and tools they will rely on, with appropriate clarity on the role that governance attributes will play. The EDA questions the appropriateness of relying on governance data, potentially in isolation of other factors, or to inordinately weight governance data when making such an assessment.

Transition

The EDA proposes that the OEB provide an adequate transition period for LDCs to implement any changes to governance structure (e.g., to observe the natural expiration of the terms of existing directors) and assess their position on the guidance provided and the impact of any changes.

2) Comments on Topics Identified by the Ontario Energy Board

Director Independence

Director independence is one aspect of good governance. The Draft Report's unstated premise appears to be that independence is a unique source of value to the benefit of the corporation. Whether independent or not, all directors owe a fiduciary duty and a duty of care to the corporation. Independence may be more appropriately regarded as one of the resources to be managed when providing good governance. In the view of the EDA, independence is but one attribute to be considered when selecting board members. Concerns around lack of independence, quality of independence or conflicts of interest can also be addressed through training, Codes of Conduct, provision of expert advice, etc. Elevating independence above other skills, attributes, processes, and so on may not be the most effective way to substantively achieve improved corporate governance.

LDC members noted that another lens for evaluating Director independence is longevity of service. It has been noted that 9 or more years of service on a Board undoes any past status of independence.¹ LDC Boards make decisions that impact the utility in the long term; for example, infrastructure investment decisions have 50-year life spans, and the investment decision made by today's Board will create

¹ Section B.1.1, UK Corporate Governance Code (Financial Reporting Council) 2016

implications or limitations for succeeding Boards. The EDA acknowledges that long service creates institutional knowledge but may risk objectivity.

The EDA observes that the OEB is exploring the range of reasonability of director independence. While the theoretical range is 0% - 100% the OEB is proposing a narrower range of 51%-100%. The need for, and fulfillment of, independence should be informed by context (e.g., how voting rights are assigned, whether directors can or must opt out of decisions based on whether they are conflicted).

The EDA notes that the Draft Report's recommendations do not take into account the nature of the ownership (e.g., whether the utility is owned directly by one or more municipalities, that has a range of other investments under its supervision, is closely held or widely held, is held by a holding company) or the composition and size of the holding company board. This approach, while introducing objectivity, risks overlooking inherent "checks and balances". It is also unclear whether the proposals will give rise to excessive costs; for example, if the utility is truly an operating division of a larger entity and is not the dominant investment of the larger entity there is the potential that providing two levels of governance may not be cost effective. Similarly, LDCs whose licensed service area is congruent with the municipal boundaries of their 100% owner may benefit from representation and participation on the Board from a higher percentage of directors drawn from their shareholder due to the shareholder's unique ability to balance the interests of the community. The OEB should be open to the resulting beneficial alignment of shareholder and customer interests in light of the inherent ratepayer perspective held by municipal officials.

LDCs understand and have fulfilled the OEB's Affiliate Relationships Code's (ARC) definition of independence. The EDA seeks clarity as to the suitability of this definition for governance purposes. It would be helpful for the OEB to explain how compliance with the ARC, pursuant to Licence condition, aligns with the OEB's guidance on Director independence.

Director Skills and Continuing Education

LDC ownership and governing bodies are designed in a variety of ways to achieve alignment while providing appropriate governance in light of the business combinations, investment risk, business risk and other considerations. The LDC's ability to attract and retain directors with the appropriate skill sets, experiences and mind set is key. The more onerous the independence requirement the greater the need for comprehensive industry orientation and ongoing training and, by implication, a shorter productive or useful life to the corporation. In smaller communities, which are expected to have a smaller pool of eligible candidates, this outcome may be especially daunting. The EDA observes that the lack of director education and training is not, in isolation, an indicator of poor or weak governance.

All LDCs are constantly identifying and assessing innovation. There is a need for governance skills and education to evolve, for example either in advance of, or concurrent with, the evolution of technology. Utilities will need sound processes and financial resources to attract and retain directors with new skills and outlooks and who are capable of overseeing these transformations in the best interests of the corporation. The possible future transformations of utilities from delivery agents to DERs or active system managers or integrated enterprises is not expected to be achieved through the application of rigid standards that suit a different risk set and traditional technology.

Governance Committees and Structures

LDCs have adhered to the provision of good corporate governance by appropriately constituting and mandating standing Board committees and structures. While all LDCs have commensurate needs for governance, its provision depends on business pressures, risks and risk profiles and other factors. There are a variety of mechanisms available to deal with emerging issues including the ability to constitute a committee or another structure to re-assign the available resources. The EDA agrees that committees can be an efficient means of allocating time to specific functions and making use of specialized skills of members to perform key functions. However, it is important to recognize that there are other ways to ensure the appropriate skills, knowledge and outlooks are leveraged in performing key functions and effective decision making (e.g., preparation of white papers, evaluations provided by subject matter experts, outsourcing analysis to expert third parties). All LDCs strive for the effective and efficient operation of their Board of Directors. In some cases, a Board of Directors may need to convene as a committee of the whole or in a special meeting to investigate a major issue or development (e.g., to provide appropriate governance on issues that broadly engage the utility). Flexibility should be provided to allow the Board to establish the structures it requires to best accomplish its governance obligations.

Documentation and Practices

LDCs are mindful of evolving best practices across all areas of their operations, including the provision of good governance. LDCs recognize the value of clear and correct documentation of governance processes and Board of Director policies (e.g., recruiting standards, orientation practices). Documentation is purpose driven and fit for purpose. The EDA submits that whether documentation exists or not is not indicative of a gap or shortcoming in any aspect of governance.

There is a question about the nature of the documentation that should be sought by the OEB. For example, the OEB's need for the provision of documentation on the director orientation processes and practices is not clearly related to the OEB's mandate of good economic regulation or to the OEB's perceived issue of governance by rate regulated entities. The EDA questions whether mandating the provision of biographical information on the members of their Boards and governing bodies risks breaching privacy legislation. The EDA suggests that the OEB analyze this aspect of the proposed information gathering to determine if it conforms with applicable privacy legislation.

Reporting and Record Keeping Requirements

The EDA notes that the OEB is providing governance guidance to all rate regulated entities and proposing mandatory RRRs. It is inconsistent to require mandatory reporting on the adoption of guidance.

Without a clear understanding of the drivers of the OEB's interest in the provision of good governance LDCs are uncertain of what issue or issues the OEB is either seeking to address or to guard against. Knowledge of the OEB's intent or purpose would bolster the effectiveness of the proposed guidance and associated reporting requirements (for example: is the Draft Report addressing outlier LDCs whose governance may - or may not – be a factor contributing to the OEB's impression of how well run the LDC is, and whether it is being appropriately responsive to customers). With respect, there are other ways to provide good economic regulation to any potential outlier LDCs and to do so in a way that does not impose

burdens on well-functioning LDCs. One such device for any outlier LDC may be to appropriately engage the LDC's financial auditor to express an opinion on quality of governance provided by the Board.

The EDA advocates for purpose driven filing requirements and RRRs. Until a clear statement of purpose is available the EDA suggests that the OEB consider the suitability of Chair self-certification. The EDA notes that the OEB's CEO self-certification process is well established, well understood and is considered to be working well. The EDA also seeks to understand whether the OEB contemplates making the information on LDCs' provision of governance public.

The EDA questions the proposed annual reporting. Governance has an enduring quality and good governance evolves over time. The OEB's Minimum Filing Requirements for rate rebasing applications and Custom Incentive Rate-making applications includes filing materials on governance policies and practices. LDCs would appreciate clarification on the value of filing identical materials with the same regulator and see merit in RRRs that document changes in governance policies and practices rather than annual reporting.

3) Concluding Comments

LDCs adhere to good governance practices and actively evolve their approaches to providing governance and governance structures. They recognize that governance is best provided through flexible structures that are purpose driven and suited to the reality of the business, the interests of the communities they serve and the stakeholders they engage. Ontario's electricity distributors have developed and tailored their governance structures, and level of formality, in a manner that balances these needs with the need to be cost effective. The EDA suggests that the OEB communicate the reason that its broad approach is preferable to a tailored strategy.