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BY E-MAIL

August 9, 2018

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto ON M4P 1E4

Dear Ms. Walli:

RE: OEB Staff Submission
Application for approvals to effect the amalgamation of Alectra Utilities Corporation and Guelph Hydro Electric Systems Inc.
OEB File No.: EB-2018-0014

In accordance with Procedural Order No. 2, please find attached OEB staff's submission in the above proceeding. The attached document has been forwarded to the applicants and to all other registered parties to this proceeding.

Yours truly,

Original Signed By

Saleh Lavaee
Advisor
Supply & Infrastructure

Attachment

cc: Parties to EB-2018-0014

OEB Staff Submission

Alectra Utilities Corporation

Guelph Hydro Electric Systems Inc.

Application for approvals to effect the amalgamation of Alectra Utilities Corporation and Guelph Hydro Electric Systems Inc.

EB-2018-0014

August 9, 2018

1 INTRODUCTION

Alectra Utilities Corporation (Alectra) and Guelph Hydro Electric Systems Inc. (Guelph Hydro) (collectively, the applicants) filed an application with the Ontario Energy Board (OEB) on March 8, 2018 under sections 18, 74 and 86 of the *Ontario Energy Board Act, 1998* (the Act) for approval to amalgamate and continue operations as Alectra Utilities.

For the reasons that follow, OEB staff accepts that the amalgamation meets the no harm test and should therefore be approved. However, there is one aspect of the application that OEB staff takes issue with: the applicants' rebasing deferral proposal. In OEB staff's view, it is not appropriate to rebase for the Guelph rate zone only in 2029, while rebasing the rest of the utility in 2027. As a consolidated entity, the new Alectra should be rebased on a utility-wide basis. OEB staff discusses two alternative rebasing options for the OEB's consideration.

2 RELEVANT REGULATORY PRINCIPLES

2.1 The No Harm Test

In its assessment of applications relating to consolidation transactions, the OEB has applied the no harm test. The no harm test was first applied by the OEB in the 2005 Combined Decision,[1] and was then incorporated into the *Handbook to Electricity Distributor and Transmitter Consolidation* (MAADs Handbook) issued in January 2016.

The MAADs Handbook states that the OEB considers whether the no harm test is satisfied based on an assessment of the cumulative effect of the transaction on the attainment of its statutory objectives. The statutory objectives considered are those set out in section 1 of the Act. If the proposed transaction has a positive or neutral effect on the attainment of these objectives, the OEB will approve the application.

The OEB recognizes in the MAADs Handbook that while it has broad statutory objectives, in applying the no harm test, the OEB has primarily focused its review on impacts of the proposed transaction on price and quality of service to customers, and the cost effectiveness, economic efficiency and the financial viability of the consolidating utilities.

[1] RP-2005-0018/EB-2005-0234/EB-2005-0254/EB-2005-0257.

2.2 OEB Policy on Rate-Making Associated with Consolidation

The MAADs Handbook allows consolidating distributors to defer rebasing for up to ten years from the closing of the transaction, but distributors must select a definitive timeframe for the deferred rebasing period.

The OEB requires consolidating entities that propose to defer rebasing beyond five years to implement an earnings sharing mechanism (ESM) for the period beyond five years to protect customers and ensure that they are included in any increased benefits from consolidation during the deferred rebasing period.

The MAADs Handbook sets out that rate-setting following a consolidation will not be addressed in an application for approval of a consolidation transaction unless there is a rate proposal that is an integral aspect of the consolidation. Rate-setting for a consolidated entity will be addressed in a separate rate application, in accordance with the rate-setting policies established by the OEB.

3 STAFF SUBMISSIONS

3.1 The No Harm Test

OEB staff submits that the evidence in this proceeding reasonably demonstrates that the amalgamation of Alectra and Guelph Hydro meets the no harm test.

3.1.1 Price, Economic Efficiency and Cost Effectiveness

The applicants identified a number of savings that will accrue from the transaction. The applicants provided a comparison of the status quo versus post-consolidation costs (OM&A and capital) over the 10-year period (2019-2028 inclusive) which reflects lower costs for the amalgamated entity. The applicants estimated the total quantified savings from synergies before transaction costs to be $40.88 million, which includes $37.04 million of OM&A savings and $3.84 million of capital savings. The applicants estimated total transaction costs to be $14.27 million, which results in net total savings of $26.61 million.[2]

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[2] OEB Staff Interrogatory 7 and 10(a).

The applicants stated that the OM&A costs savings are expected to arise primarily from reductions in labour, reductions in audit, legal and consulting expenses and reductions in Board of Directors expenses. The capital savings over the initial 10-year period arise mainly from the integration of common information systems, specialized equipment and fleet vehicles.[3]

The applicants submitted that the proposed consolidation is expected to deliver electricity ratepayer savings to the customers of both Alectra and Guelph Hydro and confirmed that projected savings, which will translate into a decrease in revenue requirement, include further synergies that are anticipated to persist beyond the proposed deferred rebasing period. The applicants stated that they expect to share savings with customers following the rebasing deferral period through lower distribution rates.

In response to interrogatories, the applicants confirmed that projected savings include integration costs but do not include transaction costs; however, the transaction costs are borne by the shareholders and do not in any way impact the ongoing cost structure of the utility.[4]

Although OEB staff notes that the degree of certainty regarding forecast savings diminishes over the length of the forecast period, OEB staff submits that the evidence provided by the applicants supports the claim that the proposed amalgamation can reasonably be expected to result in cost savings and operational efficiencies.

3.1.2 Service Quality and Reliability

The applicants stated that post-merger, Alectra expects to use Guelph Hydro's existing headquarters as its seventh service centre, while maintaining its existing six service centres located in St. Catharines, Hamilton, Mississauga, Brampton, Markham and Barrie, allowing it to service 16 communities (including Guelph) in total. The applicants stated that the Operations staff that currently respond to outages and power quality issues are expected to continue to serve the communities that they serve at present and therefore the response times will not degrade given that these staffing levels will not be changing.[5]

The applicants stated that post-merger, Alectra will maintain Guelph Hydro staff involved in responding to outages and power quality issues, year over year from 2019 to 2029, and

[3] Argument-in-Chief, p. 10 and OEB Staff Interrogatory 12(e).
[4] OEB Staff Interrogatory 12(a).
[5] Application, Exhibit B, Tab 5, Schedule 4, pp. 1-2.

they expect that the knowledge and experience will be retained in the Guelph Service Centre, notwithstanding attrition due to retirements or voluntary movement of staff. [6]

The applicants provided the five-year historical reliability metrics, i.e. System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI), for Alectra and Guelph Hydro. The applicants expect that the consolidated entity will maintain or improve upon the five-year average SAIDI and SAIFI reliability indices and the OEB's Customer Service Standard metrics for its customers, including the Guelph rate zone customers, following the consolidation transaction.[7]

In response to interrogatories relating to Conditions of Service, the applicants stated that if the OEB approves the application, they intend to consolidate the Conditions of Service in due course and inform stakeholders and customers of any proposed changes to the Conditions of Service through stakeholdering initiatives and their public notice process.[8]

Based on the evidence, OEB staff has no concerns about the amalgamated entity's ability to meet the service quality and reliability standards currently achieved by each of the amalgamating distributors.

3.1.3 Financial Viability

The application included financial statements and pro-forma financial statements of the applicants. In addition, it included details of the capital structure (i.e. debt/equity) of the parties to the proposed transaction, on an actual basis (prior to completion of the proposed transaction), and on a pro-forma basis after completion of the proposed transaction. The applicants further provided that the proposed transaction results in the pro-forma capital structure of below 60% debt, if all synergies materialize, which is consistent with an A-range credit rating.[9]

Based on the evidence, OEB staff has no concerns about the impacts of the proposed amalgamation on the financial viability of the applicants or the broader electricity industry.

[6] Argument-in-Chief, p. 9 and OEB Staff Interrogatory 11.
[7] Application, Exhibit B, Tab 5, Schedule 4, pp. 2-3
[8] OEB Staff Interrogatory 28.
[9] Application, Exhibit B, Tab 6, Schedule 4, Capital Structure, pp. 1-3

3.2 Deferral of Rate Rebasing

Alectra was formed on January 1, 2017 through the consolidation of Enersource Hydro Mississauga Inc. (Enersource), Horizon Utilities Corporation (Horizon), PowerStream Inc. (PowerStream), and Hydro One Brampton Networks Inc. (Brampton). In the decision approving the consolidation, the OEB allowed Alectra to defer rebasing for a period of 10 years, ending in 2027.[10]

In this application, Alectra and Guelph Hydro propose to maintain separate rate zones – one for legacy Alectra customers in the Enersource, Horizon, PowerStream and Brampton service territories, and one for Guelph – and to defer the rebasing of rates in the Guelph rate zone for 10 years from the date of the closing of the proposed transaction on January 1, 2019. The applicants anticipate the following with respect to rebasing:[11]

- Alectra will apply to rebase and establish distribution rates for the four existing rate zones (i.e. Horizon, Enersource, PowerStream and Brampton) effective from January 1, 2027

- For the Guelph rate zone, there will be a 10-year rebasing deferral period, ending at the end of 2028

- Alectra will apply to rebase and establish distribution rates for the Guelph rate zone effective from January 1, 2029, with distribution rates to be established through the Price Cap IR methodology thereafter

- For all five rate zones (i.e. Horizon, Enersource, PowerStream, Brampton and Guelph), Alectra will apply to rebase and establish rates for the five rate zones effective from January 1, 2032

Figure 1 in Appendix A, prepared by OEB staff, is meant to illustrate the sequence of events contemplated by the applicants.

The applicants are correct that "The Handbook does not specifically consider the circumstances where a consolidation occurs during a rebasing deferral period from a prior consolidation."[12] OEB staff would add that until this case, the OEB has not had to

[10] EB-2016-0025, Decision and Order, December 8, 2016.
[11] Argument-in-Chief, p. 14.
[12] Argument-in-Chief, p. 13.

address this question in any post-Handbook MAADs application.[13]

OEB staff has concerns with the applicants' rebasing proposal, both practical and principled.

The practical concern is that it will be difficult to evaluate the Guelph and current Alectra rate zones on a standalone basis respectively. OEB staff anticipates that in the proposed 2027 rebasing of the legacy Alectra zones, the OEB would be faced with challenging questions of how to tease out the costs and savings associated with serving the Guelph rate zone (that is, how to ensure the rates set for the legacy Alectra zones reflect the costs of serving those zones only). This exercise will be done eight years into the integration process. The company will be well on its way to operating as a single, indivisible enterprise, albeit with different rate zones.

The principled concerns are, firstly, that customers in the legacy Alectra zones will see the integration savings two years before customers in the Guelph rate zone will.[14] When the legacy Alectra zones are rebased in 2027, the new rates will reflect the lower underlying cost structure flowing from the amalgamation, but Guelph rate zone customers will need to wait until 2029 to benefit from the lower costs (and, everything else being equal, lower rates).[15] This is a question of fairness as between the two sets of customers. OEB staff submits that the OEB should have special regard, in a case like this, to the rate implications for customers of the smaller utility. This is not a merger of equals – Alectra is more than 17 times larger than Guelph Hydro in terms of customer base.[16]

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[13] Hydro One Networks Inc. acquired several smaller distributors but those approvals were granted before the MAADs Handbook was issued: Norfolk Power Distribution Inc. (EB-2013-0196), Haldimand County Hydro Inc. (EB-2014-0244), and Woodstock Hydro Services Inc. (EB-2014-0213). However, those transactions were completed in quick succession, and in each case the OEB approved a deferral of rebasing until 2020. Those transactions were also distinguishable from the current Alectra/Guelph application because they each involved a five-year rate freeze at levels 1% below existing rates. Hydro One Network Inc.'s application to acquire Orillia Power Corporation was decided post-Handbook, but was denied.

[14] The application explains that both "Guelph Hydro and Alectra customers will benefit from reduced rates as compared to the rates that would have existed if the merger transaction had not occurred": Exhibit B, Tab 6, Schedule 1, p. 3.

[15] The applicants state in their Argument-in-Chief at p.15 that, "During the rebasing deferral period, [Guelph rate zone] customers will benefit through the avoidance of two rebasing applications. Starting in 2029, those customers will further benefit from the lower underlying cost structure upon which their distribution rates will thereafter be established."

[16] Alectra currently serves 987,382 customers, while Guelph Hydro serves 55,280 customers: Application, Exhibit B, Tab 3, Schedule 4, p.1 Figure 12 and 13. This point is consistent with the MAADs Handbook, which says on p. 7: "While the rate implications to all customers will be considered, for an acquisition, the primary consideration will be the expected impact on customers of the acquired utility."

Secondly, if the applicants' proposal were accepted, the consolidated utility would not be rebased on an enterprise-wide basis until 2032 (the applicants contemplate filing a Custom IR application in 2031 for rates for all five rate zones effective from January 1, 2032). That is 13 years after the effective date of the amalgamation, which in OEB staff's view is too long. As the MAADs Handbook states on page 13, "The OEB remains of the view that having consolidating entities operate as one entity as soon as possible after the transaction is in the best interest of consumers." Although the MAADs Handbook allows for rebasing to be deferred for up to 10 years, it appears to contemplate that when rebasing occurs, it is done for the utility as a whole. For example, the MAADs Handbook explains that "A consolidated entity may apply to the OEB to rebase its rates as a consolidated entity through a cost of service or Custom IR application following the expiry of the original rate-setting term of at least one of the consolidating entities and once the selected deferred rebasing period has concluded [emphasis added]."[17]

In the 2016 Alectra amalgamation case, the OEB reiterated the principle that having consolidating entities operate as one entity as soon as possible after the transaction is in the best interest of consumers.[18] It was for that reason that the OEB found that Alectra should report under the OEB's *Electricity Reporting and Record-Keeping Requirements* on a single-entity basis, rather than on a separate-utility basis as proposed. Consistent with that decision, Alectra and Guelph now propose to report on a single-entity basis. It would be inconsistent with that decision, as well as incompatible with the manner in which Alectra intends to operate the consolidated entity, to rebase Guelph on a standalone basis, which will involve maintaining separate accounts for Guelph in order for the two entities to rebase in different years.

Certainly, there is nothing in the MAADs Handbook that expressly authorizes a staggered rebasing for different rate zones within the consolidated utility. In OEB staff's view, to allow such a staggered rebasing might blunt the benefits to ratepayers from the integration savings (or put another way, the lower cost structures). Those savings (and any savings that have not yet been fully realized) are best assessed in a rebasing application that looks at the utility as a whole. OEB staff is of the view that the consolidated utility should not wait more than 10 years (the maximum allowed under the MAADs Handbook) to bring forward such an application.

Third, under the applicants' proposal, when the Guelph rate zone is rebased in 2029, the rate term would be in effect for only three years, until the utility-wide rebasing anticipated for 2032. That is less than the standard five-year horizon under the OEB's Price Cap IR

[17] MAADs Handbook, p. 12.
[18] EB-2016-0025, Decision and Order, December 8, 2016, p. 26.

methodology.[19] Early rebasing is generally discouraged, with the utility having the onus to show that it is justified in the circumstances.[20] Frequent rebasing diminishes the incentives built into "performance based regulation."[21] The applicants argue that the MAADs Handbook permits the early rebasing of the Guelph rate zone in 2032, but in OEB staff's view, the part of the MAADs Handbook they cite contemplates a single consolidation, not a series of consolidations.[22]

Recognizing that the MAADs Handbook does not prescribe how to deal with rebasing in a case like this, where one of the applicants has already deferred rebasing as a result of an earlier transaction, OEB staff submits that there are two reasonable alternatives to the applicants' rebasing proposal:

1. Rebase the consolidated utility (all rate zones, including Guelph) in 2027; or

2. Rebase the consolidated utility (all rate zones, including Guelph) in 2029.

Either option would address the concerns raised by OEB staff above. OEB staff acknowledges, however, that neither is perfect.

Option 1 would mean that the applicants would have less than the full 10 years that the OEB affirmed in the MAADs Handbook is available as an appropriate length of time to incentivize consolidation in the electricity sector. Normally, pursuant to the MAADs Handbook, the applicants have full discretion to select a deferral period of up to 10 years, and "no supporting evidence is required to justify the selection".[23] However, in establishing that as the default rule, the MAADs Handbook did not say anything specifically about the scenario where there is more than one MAADs application in a span of less than 10 years. Indeed, the MAADs Handbook suggests that this scenario may call for examination on a case by case basis:

[19] OEB *Handbook for Utility Rate Applications*, October 13, 2016, p. 23.
[20] *Report of the Board: Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach*, October 18, 2012, p. 15.
[21] *Ibid.*, p. 11.
[22] Argument-in-Chief, p. 14. The applicants point to the table on p. 15 of the MAADs Handbook, which says that where one of the consolidating utilities is on Price Cap IR and the other is on Custom IR, "If the term for the LDC on CIR expires first, the consolidated entity may rebase following the expiration of the CIR term and once the selected deferred rebasing period has concluded." However, the header to the table indicates that it applies to the rate terms in effect "As of the date of the closing of the transaction." Thus, the table provides guidance on rebasing for the first time after the amalgamation, but does not provide guidance on subsequent rebasings such as the applicants' anticipated rebasing of all rate zones in 2032.
[23] MAADs Handbook, p. 12.

> …the OEB is aware that future consolidations may involve several consolidating distributors as well as the possibility of multiple successive consolidation transactions by a single consolidated entity. For unique circumstances, the OEB may need to assess the rate-setting proposals on a case by case basis.[24]

OEB staff submits that this application is "unique" (or at least, unprecedented) insofar as it comes before the expiry of the previously approved deferral period. It would appear that the integration of the two utilities will be largely complete by 2021, or Year 3 of the proposed deferral period,[25] and that the cumulative savings will surpass the cumulative transition costs by 2023, or Year 5.[26] A departure from the maximum 10-year deferral period available is therefore justifiable in this case.

There may be a version of Option 1 (Option 1A) that may be more compatible with the applicants' 10-year deferral selection. While not completely free of challenges in terms of tracking costs as outlined elsewhere in this submission, the applicants could include the Guelph rate zone in the planned 2027 rebasing application as part of the forecast for all rate zones for the full five years, but only propose to <u>implement</u> rebased rates for the Guelph rate zone starting in 2029. This would allow Alectra to avoid rebasing the Guelph rate zone before the 10-year deferral period has expired, and still allow for a holistic application to be filed in 2027.

Option 2 would postpone the rebasing of the legacy Alectra rate zones from 2027 (as selected by Alectra's predecessors in the Alectra amalgamation case) to 2029. Ratepayers in those zones would have to wait two more years before seeing the benefits of the lower cost structure flowing from the creation of Alectra in 2017 reflected in rates. This is problematic, but in OEB staff's view, it is outweighed by the benefit to ratepayers in all rate zones of having the consolidated utility rebased on a holistic basis. OEB staff also acknowledges that another implication of adding two years would be that the four utilities that combined to form Alectra will have gone without rebasing for between 13 and 16 years, which is a long time. Another potential concern with this approach is that it raises the prospect that a utility could defer rebasing indefinitely, if it were to continuously merge with other utilities – if a large utility were to acquire a series of smaller utilities in separate transactions every few years, the deferral period would get extended every time. OEB staff's response is that this concern could be dealt with on a case by case basis. In the circumstances of this case, where Option 2 would entail the

[24] MAADs Handbook, p. 14.
[25] The applicants forecast no transition costs beyond 2021: Figure 20 in Exhibit B, Tab 6, Schedule 1.
[26] Figure 20 (ibid.) shows that the consolidated utility will "break even" before the end of 2023. That is when cumulative net operating savings will exceed the roughly $14 million in total transition costs.

extension of the deferral period only once, by only two years, the extension is reasonable. If Alectra were to propose another MAADs transaction before 2029, the OEB would not be bound to extend the deferral period again, but rather could examine whatever rebasing proposal might be presented in light of the facts of that particular case.

The comparison of these two options illustrates that in this case, two of the principles underlying the MAADs Handbook are in tension. On the one hand is the principle that the consolidated utility should "operate as one entity as soon as possible after the transaction"; on the other is the principle that MAADs applicants should be entitled to select a deferral period of up to 10 years. Option 1 favours the first principle at the expense of the second, while Option 2 does the opposite.

If the OEB were to agree with OEB staff that these options are preferable to the applicants' proposal, the OEB could simply select one of the options and require the applicants to follow it. Alternatively, the OEB could ask the applicants to choose between Option 1 (or 1A) and 2. In OEB staff's view, providing such a choice would be more in keeping with the spirit of the MAADs Handbook, which in the normal course defers to the consolidating utility's own choice of deferral period. Offering a choice between Options 1 and 2 would allow the amalgamated company to decide on its own priorities, i.e. whether it prefers to defer the rebasing of the Guelph rate zone for the full 10 years, or to rebase all of Alectra's zones (including Guelph) in 2027.

To implement this approach, the OEB could include a condition of approval requiring the applicants to advise the OEB which of the options it selects within a specified period of time following the decision, perhaps at the same time the applicants notify the OEB that the amalgamation has closed.

3.3 Earnings Sharing Mechanism

OEB staff has no concerns with the applicants' proposed earnings sharing mechanism (ESM) for the Guelph rate zone, which is consistent with the MAADs Handbook. For years 6 to 10 of the rebasing deferral period, earnings in excess of 300 basis points above the OEB's established regulatory return on equity (ROE) for the consolidated utility would be shared on a 50:50 basis between the utility and ratepayers. At this time, however, the applicants note that they do not anticipate earnings in excess of 300 basis points over the regulated ROE between years 6 to 10.[27]

[27] OEB Staff Interrogatory 21.

If the OEB were to accept OEB staff's suggestion that the Guelph rate zone and the legacy Alectra rate zones be rebased together, and the applicants select Option 1 (2027 rebasing), then the only consequential change to the ESM for the Guelph rate zone that would be required would be that it would end in year 8 rather than year 10 (upon rebasing) – OEB staff does not suggest that it start any earlier than year 6. If the applicants select Option 2 (2029 rebasing), no change to the proposed ESM would be necessary for Guelph but OEB staff's view is that the ESM in place for the legacy Alectra rate zones would need to continue to 2029 (i.e. an additional two years).

3.4 Other Requested Approvals

As part of the proposed amalgamation, the applicants have requested approval to:

- transfer Guelph Hydro's generation licence and rate orders to Alectra, under section 18 of the Act
- cancel Guelph Hydro's electricity distribution licence, under section 77(5) of the Act
- amend Alectra's electricity distribution licence, under section 74 of the Act
- continue to track costs to the existing deferral and variance accounts

OEB staff has no objections.

3.5 Standard Conditions of Approval

OEB staff notes that in the decision approving the creation of Alectra (EB-2016-0025), the OEB included a requirement for the newly formed utility to promptly notify the OEB of the completion of the transaction. In addition, an 18-month sunset clause was included, meaning that leave to amalgamate would expire after 18 months. Both conditions are fairly standard in MAADs cases, and OEB staff suggests that they be included in this case as well.

All of which is respectfully submitted.

OEB Staff Submission

Appendix A

Alectra Utilities Corporation

Guelph Hydro Electric Systems Inc.

Application for approvals to effect the amalgamation of Alectra Utilities Corporation and Guelph Hydro Electric Systems Inc.

EB-2018-0014

August 9, 2018

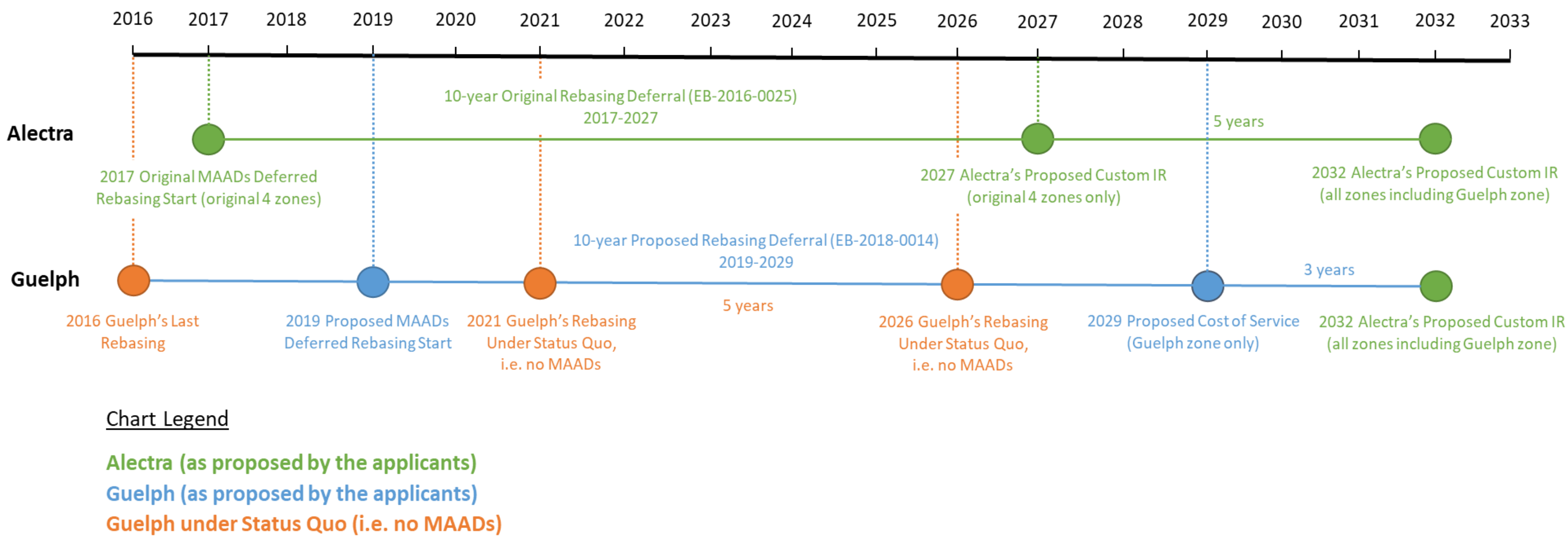

Figure 1: Applicants' Rebasing Assumptions