Ontario Energy Board (OEB)
2300 Yonge Street, 27th floor,
P.O. Box 2319, Toronto, ON, M4P 1E4
Attn: Nancy Marconi, Registrar
Submitted via Regulatory Electronic Submission System (RESS)

February 29, 2024

RE: EB-2023-0188 - Feedback on the OEB Staff Discussion Paper Evaluation of Policy on Utility Consolidations

Dear Ms. Marconi,

In mid-2023, the OEB launched a review of its Policy on Utiliy Consolidations, and promptly kicked-off stakeholder engagement in August and September of 2023. Elexicon met with OEB Staff in September to provide its recommendations for areas of improvement within current policy. Elexicon was pleased to participate in this process and is encouraged to see numerous stakeholder observations recorded and addressed in this Staff Discussion Paper (the “Paper”). Elexicon commends the OEB for undertaking a well-informed and focused scoping exercise to ensure the consultation could proceed efficiently and address near-term concerns.

The paper’s conclusions strike a balance between stakeholder interests and the Auditor General’s (“AG”) observations and recognize the emerging challenges that utilities are facing such as net zero carbon initiatives, cyber security, and management of distributed energy resources. While Elexicon is supportive of many of the recommendations in the report, Elexicon is concerned that the report and associated policies do not provide sufficient flexibility and access to resources necessary to meet the stated challenges. Left unaddressed, this will have the unintended effect of disincentivizing future merger transactions.

We are grateful to the OEB for leading this thorough, yet efficient consultation, and look forward to further engagement with the OEB on this critical policy and related issues.

Sincerely,

Stephen Vetsis
Vice President
Regulatory Affairs & Stakeholder Relations
Elexicon Energy Inc

General Comments on the Engagement and the Staff Paper

Elexicon is pleased that OEB Staff have formed their recommendations from the perspective of the emerging challenges facing the sector. Elexicon fully agrees that the emerging challenges identified (e.g. net zero, electrification, cyber security risks, Distributed Energy Resources and Distribution System Operator considerations) will require utilities to increase their service capabilities. These changes require regulatory frameworks that can account for uncertainty and provide flexibility so that utilities can adapt their operations and meet customer expectations.

Elexicon agrees with Paper's overall assessment that no major changes to *the Handbook to Electricity Distributor and Transmitter Consolidations* ("the Handbook") are required, and there are no gaps in consumer protection within the existing consolidation policy. However, the effectiveness of the Consolidation Policy is impacted by related regulatory instruments, such as the Incremental Capital Module ("ICM"). These related policies should be reviewed and updated in tandem with this consultation to support further consolidation in the electricity sector.

"No Harm" Test

Elexicon supports the OEB staff recommendation to clarify the definition of "no harm" to include consideration of qualitative factors and underlying cost structures. The potential improvements to service quality, reliability, resiliency, technological advancement and enhancing capabilities are indisputable ratepayer benefits, and critical endeavours that can be hastened through consolidation.

Cost Structures

Elexicon agrees with the OEB Staff's observations on the limitations of comparing rates to assess *'status quo'* and consolidation scenarios. We endorse the approach of using revenue requirement as an indication of cost structures while also taking into consideration how the evolving needs of the energy sector impact revenue requirement forecasts. OEB Staff have also correctly acknowledged the challenge in forecasting revenue requirements during a period of energy sector changes and growth. In addition to energy sector related changes, and related growth, such as provincially legislated broadband expansion and housing development, there are rapidly changing conditions affecting business in Ontario more broadly: cyber security concerns, privacy expectations, technological advancement, optimized data management and analytics, all of which are additional cost drivers that are difficult to foresee at the time of a consolidation application. As technology evolves, customer expectations of their utility also evolve and create pressure to deliver services in an efficient and modern fashion.

Deferred Rebasing Period

Elexicon agrees with the OEB Staff's assessment of the rigidity of the 'Early Termination' of the deferred rebasing period and the need to revise the language to address utility concerns and afford greater flexibility for utilities to rebase early, if necessary. Elexicon agrees with the observation that, at the time of the MAADs application, a utility may not have foresight into potential financial and/or operational issues that may arise in the running of the newly consolidated entity, and the operating environment may change for numerous reasons. In some cases, early rebasing is a reasonable option should the forecasted revenue requirement of an approved merger's business case become inadequate for a rapidly evolving sector and resulting pressures to respond to shifts in public policy. Elexicon supports the proposed changes to the existing policy to ease the evidentiary burden for those utilities seeking to rebase early .[1]

Despite these observations, Elexicon submits that the OEB should not lose sight of the role of the deferred rebasing period to incentivizing consolidation. In some instances, deferred rebasing will allow shareholders to offset transaction costs with achieved savings. This model is advantageous for both customers and shareholders, and paired with access to incremental capital, a sustainable model for incenting future transactions that catalyze efficiencies in the sector. The proposed changes suggest early rebasing as a primary tool for a utility that needs incremental resources to adapt to a changing environment. However, rebasing applications are a significant endeavor for utilities that are challenging during the normal course of business and even more challenging while a utility is trying to integrate its operations post-merger. The early rebasing option should not be the only solution available to address forecast uncertainty or incremental regulatory requirements. The OEB should strive for consolidation policies that are flexible enough to adapt to the sector's changing realities, but do not undermine its original objectives. The OEB must also be cognizant of the role that related policies, such as ICMs have on utilities when they are contemplating an acquisition. If the utility must bear most of the risk with unforeseen external factors (e.g., inflation or capital cost pressures, incremental regulatory requirements), the incentive to consolidate will be severely diminished.

Performance Metrics & Reporting

Elexicon is aligned with the OEB staff's observation that post-consolidation monitoring must strike a balance between regulatory and financial requirements and increased transparency. The existing filing requirements provide sufficient information on which to assess proposed efficiencies. Elexicon would add that, utilities themselves are inherently motivated by the structure of the transaction and the length of the deferred rebasing period to drive efficiencies and realize the savings of

[1] EB-2023-0188, OEB Staff Discussion Paper: Evaluation of Policy on Utility Consolidation, (February 8, 2024), page 22: "A consolidated entity that seeks to rebase earlier than its elected deferral period should inform the OEB of its intent and provide sufficient reason for the request."

consolidation for both shareholders and ratepayers, negating imposition of additional reporting requirements. While Elexicon recognizes the purpose of the proposed ‘mid-term’ report, Elexicon would recommend, if this proposal is incorporated into the Handbook, that additional language be added recognizing that a ‘mid-term’ report will reflect information collected on ‘best efforts’ basis. The OEB panel should afford sufficient deference and flexibility to the utility at rebasing if information or conclusions about efficiencies are clarified and evolve from the contents of the mid-term report. Any regulatory review of the ‘mid-term’ report should be read with the expectation that a final review of the efficiencies achieved will take place at the time of the consolidated entity’s first rebasing application.

Earnings Sharing Mechanisms (ESM)

Elexicon is aligned with the OEB Staff’s view of the purpose of the ESM, which balances opportunity for consolidated utility to accrue some net savings, while still protecting ratepayer interests. Elexicon agrees with the OEB Staff’s recommendation that transition and transaction costs be included in the ESM calculation. This calculation includes both costs and savings, which is necessary to ensure fairness for both customers and shareholders.

Incremental Capital Funding Availability to Consolidated Utilities

As noted, the OEB must be cognizant of the impact that related policies, such as the ICM policy, will have on utilities contemplating future acquisitions. To incent consolidation, the prospective acquiror should have reasonable access to incremental capital to respond to growth, address aging assets, or adapt/modernize its system to meet customer expectations and build upon existing efficiencies.

OEB Staff have recommended an additional filing requirement for utilities to note any known or reasonably anticipated future ICMs in a consolidation application. Elexicon would recommend language be included that this requirement will not preclude consolidated entities from seeking other ICMs not identified at the time of the merger application, and such additional ICMs will be assessed on the same basis as ICMs noted in the merger application. Utilities that elect a rebasing period greater than 5 years, will be challenged to accurately forecast all capital requirements at the time of consolidation. This is especially challenging in the context of the energy transition, evolving technology, and growing customer expectations.

In its discussion paper, OEB staff indicated that it was seeking comments on whether the OEB should implement any changes to the inflation rates used in the calculation of the materiality threshold for incremental capital funding prior to the OEB considering the ICM policy in its entirety. Elexicon urges the OEB to amend its ICM policy related to inflation as soon as possible. As noted by OEB staff, using the most recent IPI as a proxy for all years since the previous rebasing has a detrimental impact on a utility’s access to incremental capital, as it may overstate the actual inflation experienced by the utility and set an unrealistic threshold. This is a known issue that has impacted prior applications before the OEB including Elexicon's recent ICM application (EB-2022-0024).[2] In Elexicon's view, it is appropriate to review the application of the inflation factor immediately and separate from the other parameters in the ICM formula.

The ICM threshold calculation is intended to represent the amount of capital funded through rates. As such, it should track the *actual* increases in rates since last rebasing. The IPI is the only parameter in the ICM formula which would vary from year to year after the last rebasing. Therefore, it is reasonable to review and address this known issue separate from a broader ICM policy review.

In addition, Elexicon encourages the OEB to accelerate its review of its ICM policy to ensure that utilities have greater access to capital during their deferred rebasing periods. The need for incremental capital funding post consolidation was a known issue that was intended to be addressed when the Handbook and Guidelines were updated in 2015 and 2016, respectively. The application of OEB policy which consistently results in unsuccessful ICMs, can and will deter further consolidation as acquirers will be forced to assume greater risk in operating merged entities that must manage growing capital needs with limited options for risk mitigation. Such an environment can have the unintended consequence of limiting pursuit of consolidation opportunities to only the largest entities (with diverse options for capital funding and cash flow), that can absorb the capital risk.

Z-Factor – Materiality Threshold Calculation

The report includes an OEB Staff proposal that would add a new section on the Z-factor materiality threshold which would alter the calculation for utilities that have not rebased for 5+ years. Elexicon recommends reconsideration of the proposal to adjust the materiality threshold to account for IRMs and growth in demand in these circumstances. Changing the materiality threshold reduces opportunities for recovery of costs driven by external factors uncontrollable by the utility for those that have not rebased for an extended period. Annual IRM mechanistic adjustments allow a utility some inflationary protection, but do not provide excess resources to contend with unforeseen events. The Z-factor was intended to mitigate the impact of material, prudent, and externally caused costs due to unforeseen events. The recommended changes will limit access to sufficient revenue to absorb the immediate costs of unforeseen events and increase the risk profile of mergers for potential acquirors. Using a revised materiality threshold erodes the benefits of deferred rebasing and undermines the incentives for potential acquirers. It also creates fairness issues as it treats consolidating distributors differently depending on when they last rebased.

Incremental Operations, Maintenance & Administration (OM&A):

[2] EB-2022-0024, Elexicon Energy Inc. - Draft Rate Order (July 14 2023), pages 5 to 11.

The staff report addresses two scenarios where a utility may face OM&A pressures during the deferred rebasing period. The first scenario relates to new operating costs that coincide with an ICM, creating new operational or maintenance functions that were previously not accounted for in the utility's expenses. Elexicon supports the OEB Staff's recommendation to review this issue in the forthcoming ICM policy consultation. The second scenario raised is where the OM&A needs are unrelated to a qualified ICM. Elexicon disagrees with the conclusions of the OEB staff that the existing mechanisms are adequate. The OEB's current approach to deferral and variance accounts ("DVA"), and Z-factors, relies on an evidentiary threshold that is burdensome and rigid. For example, many of the factors noted by OEB staff (e.g. cybersecurity, DERs) are ongoing requirements rather than specific events. Therefore, they would not qualify for Z-factor funding based on existing OEB requirements which makes the Z-factor an insufficient mechanism.

Even if a DVA is granted, this mechanism still requires utilities to fund these costs with existing revenue, constraining cash flow and creating additional debt pressures, until rebasing. Elexicon encourages the OEB Staff to consider a more flexible approach to allow access to incremental operating, maintenance and administrative costs which allows the utility to address unforeseen or customer-driven business conditions (i.e., housing demand, privacy and cybersecurity, non-wire solutions) during the rebasing term.

Final Observations

In the paper's conclusion, OEB Staff note the sector's evolving and emerging issues (e.g., energy transition, evolving technologies etc.) yet conclude "this situation is not new" by reference to the previous 25 years, citing changes such as rate unbundling, market opening, and smart meters. The comparison of those changes to the demands of electrification, climate change, and unprecedented cybersecurity risks, fails to recognize the gravity and complexity of current operating conditions. The tenor of the report's conclusions also raises concerns that the OEB favours consolidation policy that forces merged entities to absorb a greater quantum of risk, creating untenable operating conditions during the deferred rebasing period for small and mid-size utilities which may ultimately disincentivize future transactions.

Despite these concerns, Elexicon is appreciative of the OEB's efforts in striving for an efficient, thorough, and productive stakeholder engagement process. We also note that meeting individually with utilities and interested parties was an essential step to properly scoping the issues and ensuring interested parties can inform and advise on complex matters that deeply impact our business. This staff paper reflects many of the concerns articulated by Elexicon and recommends meaningful changes, such as the language related to early rebasing. Elexicon is eager to engage further on the issues raised such those related to the ICM policy, Z-factor mechanism, inflation parameter, as well as incremental OM&A funding mechanisms to find solutions that better enable utilities to manage risk in a rapidly evolving sector which still enabling the benefits and efficiencies gained through consolidation.