EB-2007-0662

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c.O.15, Sch. B;

AND IN THE MATTER OF the review by Board Staff of the Affiliate Relationships Code for Electricity Distributors and Transmitters.

COMMENTS

OF THE

HVAC COALITION

1. On June 15, 2007 Board Staff published a report (the "Staff Report") on the *Affiliate Relationships Code for Electricity Distributors and Transmitters* (the "Electricity ARC"). These are the comments of the HVAC Coalition with respect to the Staff Report.

2. In these comments, we have followed the same format as the Staff Report, then added a further section "Other Issues" at the end. We have not commented on all issues, but only made comments where we feel we have a specific involvement in, or connection to, the issue under discussion.

Utility Efficiency as a Code Objective

3. No submissions.

Competition as a Code Objective

4. Utilities can use (intentionally or unintentionally) their monopoly position, ratepayer dollars, and/or regulated status to reduce market competition in a number of ways:

   a. ***Subsidized Pricing.*** Through incorrect transfer pricing, unbalanced sharing of employees or corporate services, or similar means, and LDC can improve the economics of a competitive affiliate and thus make it more difficult for its competitors to compete with it on a level playing field. This is not always inappropriate. Corporate groups often use economies of scale over multiple business platforms to make each business more competitive. The difference is that in a group with a regulated entity, the prices in the regulated business are not controlled by the market, so the regulator must police the

allocation of costs or the transfer pricing. This is what happened, for example, with Enbridge in their ancillary businesses. When they were required to allocate costs fairly, they ended up selling their competitive businesses to a third party.

b. ***Provision of Information.*** The LDC can provide customer, market, or other information to an affiliate that gives it an unfair market advantage. This is not just a question of confidential information. The utility can also provide, for example, its own internal market studies, paid for by the ratepayers, and then used by competitive affiliates without cost. Competitors have a substantial cost to gather the same information (if they can access it at all), and thus are put at a disadvantage. It is also not just a question of whether information is provided. It can also be a question of timing. For example, if the utility is planning to offer a particular product or service (a CDM incentive, for example), it can provide details to an affiliate in advance of the rest of the market, so that when competition for customers commences, the affiliate is ready to go, and its competitors are not.

c. ***Joint Business Activities.*** Many utilities would like to carry out joint marketing activities with their competitive affiliates, since that gives the affiliates a market entry point that is superior to other companies. If an LDC has a joint program with an affiliate because the utility went out to tender and their affiliate fairly won a bid, there is essentially nothing wrong with that. Where utility management prefers to deal with the affiliate, without seeing if its competitors can offer better products, services, or terms, that not only implicitly hurts the utility ratepayers (since the marketing partner chosen is not the best choice), but it also unfairly limits market access for those competitive companies.

d. ***Preferred Procurement.*** One of the most common methods used by LDCs to benefit their affiliates it to sole source significant goods and services from them. By being a major customer of the affiliate, the utility in effect pays most of their bills, covers the cost of most of their staff, and allows them the freedom to build on a strong base. In the simplest case, the affiliate can underbid its competitors because its marginal costs of the next contract are lower than its average costs. Consider an affiliate that provides computerized scheduling and work management services. Pricing of the main contract, with the utility, can cover all of the development, infrastructure, and basic operating costs, all paid by the ratepayers. When that affiliate bids on a contract with another customer, it can calculate its profit without taking those costs into account.

e. ***Special Status.*** Electricity distributors are seen by the public to have a special status in Ontario. This has many roots. One, obviously, is size. Many distributors are among the largest companies, and biggest employers, in their local communities. Another is community impact. Because they were once part of the municipal infrastructure, they are seen to be one of the municipal services, even today. Because they have sizeable budgets, they can be active in charitable, public service, and other sectors within the community, enhancing their status. But more important than both of these things is the common perception that they are "government", both in the sense of who owns them and in the sense of being regulated and therefore "safe". There is a sense, in the public, that private companies, being driven by profits, cannot always be trusted. They might take advantage

of the consumer to make money. Utilities cannot and will not do that, it is thought. Their motivation is public service, and the Ontario Energy Board makes sure that they don't take advantage of anyone. The reason why utilities prefer common branding between themselves and their affiliates is that the affiliates can benefit from this association. Although in fact not different in motivation or business practices from their private company competitors, the affiliates can, if they tie themselves to the utility, be treated as if they were different. This provides them with an unfair advantage over those market competitors.

f. ***Market Control.*** As we saw in the recent Enbridge 2007 rate case, utilities can use their public stature to influence how competitive companies behave, and thus directly or indirectly benefit their affiliates. Note that involvement of affiliates is not a prerequisite for the harm this sort of activity generates. Where a utility decides to "manage" a competitive market, for whatever reason, that reduces competition and is contrary to the public interest. In the context of this consultation, that is a problem when the reason, or the result, is to benefit affiliates. The fact that the Board, in the Enbridge decision, did not expressly find affiliate benefit to be the goal, is not the end of the question. The fact that the utility was in a position to benefit an affiliate, whether it did or not, creates a policy issue for the Board to address.

5. Given the many ways in which an LDC can reduce competition in the marketplace, and thus hurt its ratepayers, we support the view that enhancing competition should be a key goal of Electricity ARC. A central aspect of the Board's function is supervising the use by utilities of their monopoly power, and ensuring that abuses do not occur. In our submission, using monopoly power to reduce market competition is just such an abuse, and it should be the responsibility of the Board to prevent it.

6. We have reviewed the submissions of the School Energy Coalition, and agree with the changes to the wording of this provision they have proposed, which in our view will strengthen the protection of the competitive markets.

7. We also believe that a more general rule against anti-competitive acts should be included in the Electricity ARC. We therefore propose the following wording:

"Each utility shall avoid utility actions that reduce competition in any competitive market in which its affiliates carry on business, or that directly or indirectly provide an affiliate with an unfair competitive advantage".

The specific provisions of the Electricity ARC seek to achieve this result through detailed rules, but in our view that leaves the marketplace open to the creativity of utility and affiliate management. The job of affiliate managers is to use every tool available to them to enhance their business success. By including a general anti-avoidance rule in the Electricity ARC, the Board would be sending a clear message that finding loopholes in ARC is not one of those tools available to affiliate management.

Definition of Energy Service Provider

8. One of the questions raised in the Staff Report is whether the current definition of "energy service provider", which includes appliance sales, rental, service and financing, energy management and CDM services, and other such activities, should be narrowed.

9. In our view, allowing utilities less tightly supervised access to already functioning competitive markets for HVAC goods and services would be a very dangerous move.

10. Right now, the rules allow utility affiliates complete and unfettered access to these competitive markets, and many utilities have such affiliates. Electricity ARC only requires that those competitive affiliates stand on their own two feet, rather than being, essentially, "divisions" of the utility. Private companies in the HVAC business have no objection to competing with these utility affiliates in most cases, because there is a level playing field.

11. It is at least arguable that electricity distributors, mostly owned by governments, should not either directly or through affiliates be in the HVAC business at all. HVAC is a competitive business, and in general allowing governments to enter into and compete in fully functioning competitive markets is not good public policy. If the City of Toronto were to set up a company to get into the pizza delivery business, there would be an overwhelming public backlash. Being in the HVAC business is no more justifiable.

12. That having been said, we are conscious that the Board's mandate is not all-encompassing, and it is not immediately obvious what part of the Board's mandate would be engaged if it considered banning utility affiliates from competitive HVAC markets altogether. Even if that is the best public policy, it may be a policy decision for the Legislature, not the Board, to decide.

13. What the Board can and should do, though, is ensure that as long as utility affiliates are competing in these markets, they must do so on the same basis as private companies, and without in any way getting a "leg up" from their utility sister company.

14. For that reason, we support continuation of the current "energy service provider" definition, and in fact would like to see it clarified to ensure that financing of energy equipment or services is unambiguously included. As we will note later, we will also propose limits on common branding for affiliates operating in competitive markets.

Confidential Information

15. We have reviewed the submissions of the School Energy Coalition with respect to defining and controlling the provision of information, and support those submissions for the reasons set forth therein.

Sharing of Employees

16. In our view, sharing of utility employees that either deal with customers, or have access to confidential information, with any affiliate should not be permitted in any circumstances. In particular, an exception should not be made for affiliates operating outside of the utility's franchise area.

17. The first problem with this is customer confusion and implied regulatory endorsement. If an employee of Horizon Utilities is in Burlington selling CDM services, does it matter that he or she is outside of the Horizon service area? The homeowner still sees a utility employee, and is thus not aware that they are dealing with a private, competitive company. Not only will their approach to the person be different ("I can trust this guy; he's from the utility"), but what happens if something goes wrong? Will the homeowner call the Better Business Bureau, or the OEB? It is submitted that at least some of those homeowners will expect the OEB to protect them in any circumstance in which they are dealing with a utility employee.

18. The second problem is with the information sharing. As noted earlier, if a business, including a utility, develops valuable information, the availability of that information to the competitive affiliate is wrong because of the information's value, not just because of privacy concerns. Where there is a shared employee, by definition that employee has, in their work for the affiliate, "access" to all information they have as a utility employee. The only way to police this is to prevent the sharing.

19. The question has been raised whether this rule should be relaxed for smaller distributors. In our view, that is not justifiable. A small distributor, presumably serving a smaller town or rural area, will through their affiliates be competing against smaller private companies as well. The HVAC contractor with three employees is just as hard-pressed to keep costs down as the utility affiliate with three employees, and letting the utility affiliate share an employee or two with the utility makes competition between them less fair. Further, if a small distributor elects to have an affiliate in the HVAC business, then in our view they accept the responsibility to make that business viable on its own, without the help of the utility. If it is not viable, it should be allowed to die. That's what competitive markets do.

Independent Directors

20. We have reviewed the submissions of the School Energy Coalition on this issue, and agree with them that requiring independent utility boards, with the addition of a certificate of compliance with ARC, would improve utility governance and strengthen ARC protections.

Transfer Pricing Rules

21. Generally speaking, the current rules for transfer pricing between utilities and their affiliates work quite well. With one exception, if the Board were to try to revise these rules, it would be solving a problem that is not there.

22. That having been said, we see some value in importing the Gas ARC rules into the Electricity ARC. Not only would it provide consistency between the two codes, but it would codify practices already in place in the electricity sector.

Outsourcing Utility Activities to an Affiliate

23. HVAC Coalition members are generally not directly affected by utility outsourcing, although of course they are indirectly affected if one of the reasons for the outsourcing is to reduce regulatory oversight. To the extent that outsourcing is directed at this purpose, we believe it should be tightly restricted. Utilities should not be able to use corporate structure planning as a technique to limit the role of the regulator. For example, outsourcing billing to an affiliate, and in the process allowing the affiliate to control access to the bill, would in our view be an inappropriate outsourcing activity.

24. Subject to that general point, we have no submissions on this issue.

Shared Corporate Services

25. The problem with loose supervision of shared corporate services is that, at the management level, there is always a question of divided loyalties. Unless the Board requires separate management of utilities, this is not really solvable.

26. Other than that, we have no submissions on this issue.

Asset Transfer-Pricing Provisions

27. From our point of view, there are two potential harms to be addressed in the asset transfer pricing rules:

    a. A sale at an undervalue of utility assets to an affiliate capitalizes that affiliate through a subsidy from the utility. This provides the affiliate with a substantial and unfair competitive advantage. For example, if a utility develops a work management system at a cost of, say, $10 million, but the finished product is worth $30 million, selling it to an affiliate at $10 million would, but for Electricity ARC, give the affiliate a $20 million head start.

b. Implementation of risky projects within the utility, followed by transfer of the assets to an affiliate, allows the affiliate to avoid the risk of cost overruns, project failure, and the like. In the work management example above, even if the value were $10 million, the affiliate would still have benefited from the offloading of risk.

28. With this background, we believe that importing the Gas ARC transfer pricing rules into the Electricity ARC would strengthen the latter. In addition, we propose that, where a utility takes on a significant level of risk in the development of any asset, it should be required to set a value on that risk and include that value in the cost of the asset for the purpose of determining the greater of cost or fair market value in an asset transfer.

Exemption Process and Small Distributors

29. No additional submissions.

Other Issues

30. ***Co-Branding.*** HVAC Coalition is very concerned with the practice by electricity distributors of building brand value with utility funds, and giving free access to that brand value to competitive affiliates. This raises issues of customer confusion and fair value.

31. The customer confusion issue is a simple one. Customers cannot be expected to distinguish easily between Toronto Hydro-Electric System, Toronto Hydro Energy Services, and the many other potential names that can be used for competitive affiliates. This is both harmful to customers, and anti-competitive.

32. From the point of view of the HVAC community, there is an additional problem. HVAC companies like Reliance Home Comfort, ClimateCare, Direct Energy, and Service Experts, among others, spend a lot of money to build their brand recognition and value. All of that spending must be built into the price of their goods and services. By contrast, if a utility is allowed to use the utility branding for an affiliate, the ratepayers pay the cost of building the brand in their electricity distribution rates, and the competitive goods and services of the affiliate are free of that cost. All other things being equal, the affiliate has an unfair advantage over its competitors.

33. We believe that the only reasonable solution to these two problems is to require each utility affiliate operating in competitive markets to use branding that is in all respects distinct from, and not associated with, the utility brand, name or logo. Thus, we propose that Section 2.5.3 of the Electricity ARC be amended to add the following sentence:

"Each brand, corporate or business name, logo, or other trade mark or trade name used by an affiliate shall be distinct from, not associated with, and not confusing with, the brands, corporate and business names, and logos of the utility."

34. ***Billing Access.*** The Electricity ARC does not currently prohibit LDCs from giving their competitive affiliates preferential access to the utility bill, either as a method of billing and collecting from the affiliate's customers, or as a vehicle for marketing the affiliate's goods and services. We believe that the Electricity ARC should provide that an LDC shall only include on or in its bill to utility customers:

    a. Utility charges and marketing messages; and

    b. Charges and marketing messages from competitive companies, including affiliates, if all competitive companies have non-discriminatory access to the service under a plan approved in advance by the Board.

35. ***Market Control.*** We have noted earlier that utilities can benefit their affiliates indirectly through market control, and we cited the example of EnergyLink. In our earlier submissions, we have proposed a general anti-avoidance rule to deal with that in the affiliate context. However, as we have noted, that is not the full extent of the problem. Even if a utility's actions to control competitive markets are not intended to benefit affiliates, they are still harmful.

36. We therefore ask for the Board's guidance in proposing a process to consider how the Distribution System Code can be amended, or such other actions taken, as may be suitable in the Board's view to deal with the issue of inappropriate use of monopoly power to control or influence competitive markets.

Conclusions

37. The HVAC Coalition very much appreciates the opportunity to participate in this consultation, and we hope our input provides a new perspective that is useful to the Board in its consideration of the issues. We would like to continue to participate in any followup processes on this important subject.

All of which is respectfully submitted on behalf of the HVAC Coalition as of the 20th day of July, 2007.

SHIBLEY RIGHTON LLP

Per: _____
Jay Shepherd