

SMITH LYONS

ENERGY BULLETIN

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Ontario Energy Board Decision (Standard Service Supply)

The Ontario Energy Board issued its decision in RP-1999-0040, which promulgated the Final *Standard Supply Service Code*, on Monday, October 18, 1999. For the most part, the Board sustained the provisions of the *Draft Standard Supply Service Code* prepared earlier by Board staff.

To provide a context for the decision, it is worth restating the objectives the Board set out in the *Draft Code* for standard supply service ("SSS"). These were six in number and they are:

1. customers should have access to electricity through their current supplier at market-based prices;
2. customers should not be locked into the standard supply service (SSS), but should be free to move to and from the distributors' obligation to sell electricity in order to facilitate retail competition;
3. the provider of SSS should be indifferent with respect to whether a consumer switches to an alternative supplier;
4. SSS is a regulated activity that should not cross-subsidize competitive activities;
5. a distributor should not bear any [significant] volume risk or price risks in providing SSS; and,
6. rules related to SSS should ensure that all retail market participants operate on a level playing field.

The Board considered six issues in its decision. They are:

1. the pricing mechanism for SSS;
2. restrictions on energy procurement by distributors for SSS;
3. marketing restrictions on retailers who provide SSS;
4. ownership of generation by distribution utilities;
5. the billing mechanism for SSS; and,
6. customer mobility.

Issue 1 - Pricing of the SSS

The Board decided that the distributors should provide their smaller customers (loads of less than 50 kw) with a one year fixed price offering to reduce volatility and to maintain greater continuity with their existing service. The one year price will be based on the IMO's twelve-month spot price forecast. At the end of the year, the customer will receive a true-up to reflect the "actual average spot market price" paid by the distributor. The true-up amount will be included as a component of the next year's fixed price. The decision

differs from the *Draft Code*, which had recommended a spot price pass-through. Over a multi-year period, the total amount paid by the small consumer is likely to be the same as under the spot price pass-through. In any given year, however, the fixed price, based as it is on a forecast, can be very different from the average spot price experienced through the year. The Board will allow distributors who wish to offer small customers the spot price pass through to apply for an exemption to the "fixed price" rule. But distributors cannot offer both options. The Board will fix the distributor's administrative charge to the customer as part of the rates case. The larger volume consumers must receive the spot price pass-through.

Issue 2 - Procurement of Power for SSS

Section 29 of the *Electricity Act* provides that a distributor can fulfil its SSS obligations either directly, through a third party, including an affiliate, or a combination of the above. The Board upheld the *Draft Standard Supply Service Code*, which provides that a distributor that provides SSS directly must purchase the electricity in the spot market. The Board was of the view that the two alternative approaches suggested by intervenors, the portfolio procurement approach through competitive bidding and a competitive benchmark system with regulatory oversight, were incomplete and would in any event require significantly greater regulatory effort than the *Draft Code* spot market purchase proposal. The Board questioned whether the additional effort was warranted given that the "SSS may be considered a transitional arrangement".

The Board was also concerned with utility risk and decided it was too risky for the utilities to be procuring power for large customers anywhere but in the spot market. With respect to the utilities' purchases on behalf of small customers, it proposed the establishment of a deferral account, which would operate in a manner similar to the gas utilities' Purchased Gas Variance Account, to reduce utility "in year risk" arising from buying in the spot market and selling at a fixed price. The Board also stated it would consider special circumstances, such as that of Sault St. Marie, which has long-term electricity supply contracts with Great Lakes Power. Each such case will require a separate application and Board approval.

Third parties under contract with the distributor (including affiliates) to procure electricity for its SSS load are not required to purchase in the spot market. The Board will need to be satisfied, however, that in addition to the contractor meeting the licensing, capacity, and prudential requirements in section 2.2.3 of the *Code*, there is no incremental risk to the utility and the ensuing rates are just and reasonable, including the fact that they are not higher than they would otherwise be because of the contractor's procurement arrangements. In effect, the distributor will have to show that its customers' electricity costs arising from the third-party procurement are no higher than the forecasted fixed price set by the Board in any given year. To this end, the Board may also develop rules in respect of "agency" contracts between distributors and third-party procurement agents, such as annual price re-determination clauses and no limitation on volume adjustments to allow for utility customer mobility. Subject to such rules, the third-party procurement agents will be free to enter into longer term fixed price or indexed, fixed-volume contracts with suppliers. They will have to share the risks of such arrangements with their suppliers rather than the distributor. The Board may also benchmark third-party procurement involving the distributor's affiliate or a "joint venture" to which the affiliate is a party, against procurement contracts through unaffiliated third parties.

In our view, the Board was clearly not convinced that non-spot market procurement alternatives would be cheaper for smaller utility customers. They were very concerned about undue regulatory burden. They were not moved by arguments that access to the SSS segment of the retail market was critical for new generators and green-power generators. The Board acknowledged that there "may be some lost opportunities for new generators and green-power suppliers" but noted that the competitive retail market was available to these parties and, in any event, the wholesale market was a better place to implement government policy on green power.

Issue 3 - Restriction on SSS Providers

The Board upheld sections 2.2.4 and 2.2.5 of the *Draft Standard Supply Service Code*, which provide, respectively, that a third party, including an affiliate, which provides SSS supply on behalf of a distributor may not retail electricity to consumers in the distributor's service territory and may not engage in marketing of electricity or gas in that service territory. While admitting that these restrictions may impose incremental costs on these third parties and may restrict the number of retailers in the market, on balance the Board decided to maintain the restriction for four reasons: to foster competition by avoiding disincentives to new entry; to avoid customer confusion; to protect customer information (data fire walls within a corporation are not enough and require too much regulatory surveillance); and to prevent cross subsidy of the competitive retail business by the SSS business. In light of its decision to maintain the *Draft Code* restrictions, it amended section 2.5.7 of the *Affiliate Relationships Code* to allow the distributor to transfer customers to an affiliate for purposes of that affiliate meeting the distributor's SSS obligation without the customers' written consent. The Board's decision in this area is based on the assumption that the retail market will be attractive enough to develop without being jump-started by the affiliates using the SSS business.

Issue 4 - LDC or LDC Affiliate-Owned Generation

The Board declared that any self-dealing related to power procurement should be avoided. However, if the third-party procurement agent purchases distributor or distributor-affiliate owned generation as part of its SSS supply portfolio, the distributor must give no preference to affiliated supply and must disclose the supply arrangements and sufficient price data to enable the Board to determine that the SSS rate, determined in whole or in part on the basis of the purchased generation, is just and reasonable.

Issue 5 - Billing for SSS

The Board reaffirms sections 2.7.2 and 2.7.3 of the *Code*, which provides that bills sent to SSS customers by a contracted supplier (including an affiliate) shall reference no retailer other than the distributor, and must contain no marketing information or promotional materials except distributors' materials that it must send to customers as part of its regulated distribution function. The direct relationship between the distributor and customer must extend to SSS supply.

Issue 6 - Customer Mobility

The Board decided that in accordance with section 29 of the *Electricity Act* and section 2.1.2 of the *Code*, the distributor should not restrict customer mobility in any way (except for reasonable administrative requirements) whether it procures directly or through a third party. In the latter case, as noted above, the Board anticipated that the distributor would contract with the third party to minimize any price and volume risk to itself.

Implementation

The Board stated that over the next month it will consult with stakeholders on the implementation of the *Code*, including the mechanics of the pricing mechanism for SSS (to be included as part of distributors' rate filings) and guidelines on procurement and tracking.

Summary and Implications

The Board has anchored its decision, in our view, on its view of smaller consumers' interests and the need to avoid complex regulatory mechanisms. Consumers will be protected, in its view, by retail competition on a level playing field and by the right to access the spot market price, albeit with a slight lag, through their local distributor. The Board made its decision in the face of enthusiastic arguments to the contrary by a number of parties, in particular those representing some distributors and some producers (but with the support of others including the Consumers Association of Canada).

Once the market is open in late 2000, large customers, whether connected directly to the transmission system or embedded in distribution systems, remain free to enter into bilateral contracts with marketers, OPGI, or other producers, on whatever terms they can negotiate, as can smaller customers (assuming as a practical matter their loads are aggregated in some fashion). However, retailers, either producers or marketers, will not be able to sell on a fixed price basis directly to distributors.

Distributors will have to take care, in the event they delegate their SSS obligation to an affiliate or some other third party, to ensure that the resulting arrangements are no less attractive to their customers than had they procured directly from the spot market. They can specify this requirement in their contract with such third party, along with any more specific requirements the Board may impose.

The decision provides both opportunities and challenges for retailers, both "independents" and utility affiliates or a combination thereof. The independent retailers will not have to face competition from retail affiliates of distributors organized around the SSS but they will have to move aggressively to validate the Board's apparent confidence that retail competition will develop in the absence of the critical mass of customers afforded by the distributors proposals to transfer their customers "en masse" to their retail affiliates. The distributors will face a similar challenge in deciding whether to establish a retail affiliate, which will be competing with Direct Energy, Suncor, et al. (at the small customer level), and a host of players (many of them gas marketers) in the larger markets. The affiliates will have their own advantages including their names, their electricity expertise, and the distributor's reputation. While the *Energy Act* and the Board appear to contemplate that the SSS service will be a transitory service, the experience in the gas markets suggest that it will be with us for some time yet, in effect, for so long as it takes for a competitive retail market to develop. The Board may be proceeding in a step-by-step fashion here.

Producers, including green energy producers, will not have the support of fixed or indexed bilateral contracts with distributors that purchase SSS supply directly. However, they will be able to negotiate fixed or indexed contracts with a third party procurement agent to whom the distributor delegates its SSS procurement, provided that the contracts are structured in such a way that taken together with any commitments the procurement agent gives the distributor, they do not result in higher prices to customers or less mobility for customers than results from spot-market procurement.

For more information on Standard Service Supply, contact J. Thomas Brett at 416-369-4628.

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