Regulatory Independence: The Impact of the Green Energy Act on the Regulation of Ontario's Energy Sector

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Introduction

The *Green Energy and Green Economy Act,* which for purposes of this paper will be referred to as the "GEA", made significant changes to the regulatory regime for Ontario's energy sector. It will be the burden of this paper that many of the changes limit the independence of the Ontario Energy Board's ("OEB" or "Board") authority to carry out its core obligation of setting just and reasonable rates. It will further be the burden of this paper that that limit is not in the public interest.

Whether what the GEA has done to the Board's independence is a good or a bad thing depends, on one level, on one's economic interest. For example, for those developing renewable energy facilities, it is arguably a good thing. The changes made by the GEA substantially reduce regulatory hurdles to the approval of the transmission and distribution connections to those renewable energy facilities. By contrast, for local distribution companies ("LDCs"), the obligation to make those connections imposes a burden which they might not, all else being equal, wish to assume.

The success or failure of the regulatory system in achieving its public policy objectives should not be measured by the effect, in the short term, on the economic circumstances of any one constituency or the achievement of the policy objectives *du jour* of the government.

I will review, first, the public policy objectives of the regulatory system, and the powers given to the OEB to pursue those objectives. I will then review the changes which the GEA made to the OEB's powers, and the OEB's response to those changes. Finally, I will discuss the implications of these changes for the regulatory system and, more broadly, for public policy.

The Objectives of Regulation

The transmission and distribution of electricity is a monopoly function. Electricity is an essential commodity. The availability, and cost, of electricity play critical roles in the wellbeing of individuals, businesses and institutions.

Consumers, whether individuals, businesses or institutions, need to be protected from the abuses which naturally flow from monopolies. The legislature has determined that it is the role of the energy regulator, the OEB, to provide that protection. It is also the role of the energy regulator to ensure that electricity distributors and transmitters remain economically viable. Taken together, those things constitute the objectives of regulation. Achieving those objectives protects the public interest.

The balance between the respective interests of consumers and utilities has been described as the "regulatory compact". The role of the energy regulator, with respect to this regulatory compact, was described by the Supreme Court of Canada, in a foundational decision, in the following way:

The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested. By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise.[1]

The obligation of utilities to protect the interests of their ratepayers, and the corresponding obligation of the energy regulator to ensure that they do so, has long been recognized by the courts. That obligation was most recently expressed, by the Ontario Court of Appeal, in the following terms:

The principles that govern a regulated utility that operates as a monopoly differ from those that apply to private sector companies, which operate in a competitive market. The directors and officers of unregulated companies have a fiduciary obligation to act in the best interests of the company (which is often interpreted to mean in the best interests of the shareholders) while a regulated utility must operate in a manner that balances the interests of the utility's shareholders against those of its ratepayers. If a utility fails to operate in this way, it is incumbent on the OEB to intervene in order to strike this balance and protect the interests of the ratepayers.[2]

Powers Given To The OEB To Achieve The Objectives Of Regulation

The principal responsibility for achieving the objectives of regulation lies with the OEB. The principal mechanism by which the OEB achieves those objectives of regulation is the setting of just and reasonable rates.

The OEB's power to approve electricity rates is set out in section 78 of the *Ontario Energy Board Act 1998* (the "OEB Act").[3] The relevant portions of section 78 are the following:

78.(2) No distributor shall charge for the distribution of electricity or for meeting its obligations under section 29 of the Electricity Act, 1998 except in accordance with an order of the Board, which is not bound by the terms of any contract.

78.(3) The Board may make orders approving or fixing just and reasonable rates for the transmitting or distributing of electricity or such other activity as may be prescribed and for the retailing of electricity in order to meet a distributor's obligations under section 29 of the Electricity Act, 1998.

The OEB Act does not define "just and reasonable", or otherwise indicate what the term is to mean. Instead, the OEB is granted a broad discretion to determine what is just and reasonable. The legislature granted the OEB this broad discretion for many reasons. Among other things, a broad discretion is necessary to ensure that the OEB has the flexibility to balance competing interests, and to do so independently of the political exigencies of the day. Simply put, the broad discretion to act independently was seen by the legislature as essential to the Board's ability to protect the public interest.

The courts have repeatedly confirmed that the OEB has a broad discretion to determine what is just and reasonable when setting rates. For example, the Ontario Court of Appeal, in the THESL Decision referred to above, stated: "The case law suggests that the OEB's power in respect to setting rates is to be interpreted broadly and extends well beyond a strict construction of the task".[4]

In like fashion, the courts have repeatedly referred to the OEB's status as an expert tribunal in making decisions within the scope of its jurisdiction, and in particular in setting just and reasonable rates. The Divisional Court stated that " the OEB is a highly specialized expert tribunal with broad authority to regulate the energy sector in Ontario and to balance competing interests".[5] That statement was quoted with approval by the Court of Appeal in the THESL Decision.[6]

The GEA

To understand the changes wrought by the GEA, it is useful to begin with a review of the circumstances which obtained before it was enacted. A LDC had the freedom to decide whether it wished to connect to a particular source of supply, renewable or otherwise. The discretion to make that connection had to be exercised prudently. A LDC seeking the approval to recover, in rates, the cost of connecting to a renewable energy source would have to satisfy the OEB, with evidence, that those costs were prudent. That, in turn, would require the LDCs to lead evidence that the electricity supply from the renewable resource, coupled with the cost of the connection and perhaps stranded transmission costs, were reasonable in relation to the *status quo* or other alternatives.

The GEA amended the *Electricity Act, 1998*, to require the Ontario Power Authority ("OPA") to enter into contracts for the supply of renewable energy.[7] It further amended that Act to require that distribution companies provide connections to those renewable energy sources.[8] The amendments eliminated the discretion of the LDCs to decide whether to connect to renewable energy sources. It also amended the OEB Act to include, as a condition of licences held by distributors, the requirement that distributors connect to renewable energy sources and prepare plans for the expansion of their systems to connect to renewable energy generation facilities.[9]

The effect of these amendments is to create a web of obligations which bind distributors and transmitters, a web which the Board cannot ignore. When presented with an application to approve the recovery of the cost consequences of fulfilling these obligations, the Board would find it difficult to deny recovery.

For all intents and purposes, the amendments made by the GEA have the same effect as an amendment to section 78 of the OEB Act requiring the Board to find that the cost of connections to renewable energy facilities to be just and reasonable regardless of whether these costs represent the least cost alternative to obtaining supply. Such an amendment would be a direct limitation on the Board's independence. The GEA imposes an indirect, rather than a direct, limitation on the Board's independence.

The effect of these amendments is compounded by other legislative changes introduced by the GEA. For example, the GEA also amended the OEB Act to add section 70(2.1). The provisions of section 70(2.1) are, in this context, particularly important. They require the Board to amend the licences of electricity transmitters and distributors. In summary, they provide the following:

1. LDCs are required to provide priority access to their distribution systems for renewable energy generation facilities.
2. LDCs must provide that access in the manner prescribed by the Board.
3. LDCs must prepare, for filing with an approval by the Board, plans for:

(a) the expansion or reinforcement of their distribution systems to accommodate renewable energy generation facilities; and

(b) the development and implementation of the smart grid system in relation to their distribution systems.

LDCs must do what the Board approves.

The legislation could, by its own terms, or through regulation, have specified the manner in which the connections to renewable energy sources were to be made. Instead, it specified that the Board was to determine the manner in which those connections were to be made. In doing so, the government requires the Board to implement government policy. The use of the words "in the manner prescribed by the Board" has the effect of making the Board an instrument of the government in designing the very connections that the Board must then approve. It is clearly a mechanism designed to strip a regulator of its independent status and to do what the government tells it to do.

The overall effect of these legislative provisions is this: the OEB must consider an application for the approval of rates which reflect the cost of a LDC doing what they are required by law to do, namely, connecting to a renewable energy generation facility. In doing so, the Board is considering whether to approve the cost consequences of a LDC doing what the law requires and following the very procedures the Board itself has designed. In those circumstances, consideration of whether, absent the legislative changes, the

resulting rates would be considered just and reasonable is effectively irrelevant. The result is a significant limitation on the ability of the OEB to carry out its core public policy obligation of setting just and reasonable rates guided by accepted ratemaking principles and by its perception of the public interest.

The OEB, like any regulatory agency, must be aware of and responsive to government policy. Even without the kind of intrusive provisions in the GEA, the OEB would have to balance its need for independence with its need to reflect government policy in its decision-making. The GEA has made that balancing act unattainable.

Faced with the legislative changes, and with the prospect of directives if it fails to respond appropriately, the OEB has limited options. The Board's response has been to embrace its role as the implementer of government policy. This is evident in a number of the Board's own policy initiatives.

The OEB itself has no statutory mandate to make policy. In that respect, it differs from, for example, the CRTC. Courts have recognized that, to properly and efficiently carry out their operations, regulatory agencies can set guidelines for how they will carry out their operations and, indeed, guidelines as to how they will apply tests like "just and reasonable" in the cases that come before it. The courts have also said, however, that regulatory agencies cannot be bound by these guidelines, and must consider each case on the evidence before it, and on the merits of the case. The use of guidelines is not, in this view, inconsistent with the independence of the regulatory agency.[10]

One of the Board's policy initiatives has been the issuance of "Filing Requirements", which dictate what a LDC's green energy plans must contain.[11] These "Filing Requirements" represent the Board's implementation of government policy. In the absence of section 70(2.1), there is nothing in the OEB Act which requires the OEB to develop plans for the required connections, let alone mandatory filing requirements. It should be noted that the Board has issued guidelines, in other contexts, but always for the purpose of improving the efficiency of its regulatory processes. These guidelines differ, in their character and objective, from the "Filing Requirements".

The Filing Requirements are the logical, indeed the necessary, product of the wording of section 70(2.1) of the OEB Act. But the Board has gone beyond what the legislation requires it to do, by way of implementing government policy, by taking further steps to facilitate the implementation of the policy.

The OEB has also established a number of new accounting and cost recovery mechanisms.[12] While the OEB has, in most instances, said that the use of those cost recovery mechanisms is voluntary, and will be subject to an after-the-fact review of the prudence of the LDCs' use of the mechanisms, it is safe to assume that, absent very unusual circumstances, the Board will approve the utility's use of those mechanisms in order to facilitate the implementation of the government's green energy policy.

The OEB has continued to formally recognize its obligation to protect the interests of consumers while implementing the government's green energy policy. In its first major decision, following the enactment of the GEA, considering a utility's green energy plan, the OEB refused to approve all of Hydro One Networks Inc.'s ("HON") proposed expenditures for its green energy plan for its distribution system. The Board found that the plan did not meet the expectations of the Board's filing guidelines.[13] On the surface, that suggests that the Board was preserving an independent role. But rejecting parts of the plan because they did not meet the guidelines makes the opposite point, namely that the Board had limited its freedom to consider the plan on its merits. Moreover, the Board used the funding mechanisms it had developed, to facilitate GEA-driven initiatives, to provide funding for HON to pursue parts of the green energy plan it did not otherwise approve. The Board did state that the spending pursuant to those mechanisms will be subject to an after-the-fact prudence review. However, given the Board's, perhaps necessary, embrace of the government's GEA initiatives, it would be surprising indeed if these expenditures were not found to have been prudent.

The OEB has also tried to build into its approval process some internal checks on prudence. For example, the Board's "Filing Requirements" obligate LDCs, in preparing green energy plans, to discuss their plans with the OPA and, indeed, to obtain from the

OPA what amounts to its approval for the proposed connections. The objective of this requirement is, presumably, to try to ensure that LDCs only spend money on connections to economically viable renewable energy facilities. That introduces a check on the reasonableness of the proposed costs and, therefore, on the resulting rates. That, in turn, offers some comfort to ratepayers. But that is devolving a part of the approval process onto the OPA. The OPA's decision-making processes are not subject to public scrutiny, let alone public participation. They do not, in other words, meet the requirements of the Board's rate-making processes, requirements recently reiterated by the Ontario Court of Appeal, in the following terms: "It is undisputed that the utility's full revenue requirement of $12.7 million did not undergo the usual review process which, in the normal course, would have required, among other things, notice to interested parties and an opportunity for them to make submissions at a hearing."[14] (Emphasis added.)

These observations should not be taken as a criticism of the Board's response to the GEA. Faced with the legislative changes, there is a legitimate argument that the Board had no choice but to implement the government's policy as effectively as possible. The Board has sought input from its various constituencies as to how the policy should be implemented. But none of this can disguise the reality that, in a critical area, the government has limited the Board's independence to carry out its historic mandate to protect the interests of ratepayers.

It is beyond the scope of this paper to examine what the OEB can legitimately do, in the face of the GEA, to preserve its independence. But the question is an important one one that warrants detailed analysis. In its recent decision in *R. v. Conway*,[15] the Supreme Court of Canada reaffirmed the obligation of regulatory agencies to consider the constitutionality of the legislation requiring them to take certain actions. More broadly, the *Conway* decision reaffirms the importance of a regulatory agency always determining, before taking any action, whether what it is being required to do is legally permissible. Such determinations are particularly important, given the range of initiatives, referred to below, taken by the government with the objective of further reducing the OEB's independence.

The Implications for Public Policy

What constitutes good public policy varies over time and is often in the eye of the beholder. There is certainly a compelling argument that encouraging the development, and use, of renewable energy sources is good public policy. The question is, how does the government pursue that policy, and at what cost to other values? Put another way, does the government pursue that policy at the cost of undermining the independence of the regulator, and its ability to protect the public interest?

It is also the case that the electricity sector is so critical to the health of Ontario's economy that the government must exercise some measure of control over it. And, particularly over the last two decades, the government has exercised that control, using a variety of mechanisms. The important difference is that none of those mechanisms involved a direct limitation on the power of the OEB to protect the public interest. It is in that respect that the GEA represents such a sea change, and such a threat to the public interest.

The OEB, like any regulator, must be sensitive to, and indeed in some measure responsive to, government policy. To what extent regulatory agencies must reflect government policy in their decision-making has been the subject of considerable judicial and academic consideration. There is a spectrum of opinion on that question that ranges from the view that a regulatory agency is little more than an instrument of policy implementation to the view that regulatory agencies have independent status akin to that of the Courts.

Government policy has been communicated to the OEB in a number of ways, formal and informal. The least intrusive of the formal mechanisms are the objectives listed in the OEB Act by which the OEB must be guided in carrying out its responsibilities.[16] While the OEB must take the objectives into consideration in its decision-making, it nonetheless is free to apply the objectives, as it feels appropriate, to the facts before it. The use of the word "guided", in the section of the OEB Act setting out the objectives, serves the purpose of reserving for the OEB a broad discretion as to the extent to which, and the manner in which, it applies the objectives. Among the other considerations, this flexibility is critical in light of the fact that many of the objectives are, on their face,

contradictory.

The issues canvassed in this paper have taken on a particular importance in light of several further provincial government initiatives, the objective and effect of which are to further erode the independence of the OEB. These include the recent directive requiring the OEB to develop and enforce conservation and demand management requirements on LDCs, but to do so without a hearing; the requirement that the OEB be a processing agent for the special purpose fund component of the GEA; and the requirement that the OEB take on the role of a social welfare agency in designing and implementing programs to assist low income energy consumers.

Regulatory agencies, such as the OEB, are not courts. They have no independent status under the *Constitution*. They are, to use the common term, "creatures of statute". That means they are required to do what the statute requires them to do. Also, and as noted above, they must be responsive to government policy. The issue is where to draw the line between the importance of independence and the obligation to be responsive to government policy. Given the characteristics of the energy sector, and in particular the need to protect consumers from the potential for the abuse of monopoly powers, good public policy dictates that the independence of the OEB be protected, to the greatest extent reasonably possible. The GEA's legislative limits on the Board's powers, and its use of directives, compromises that independence. In my view, that prejudices the interests of consumers and does not reflect good public policy. Interest in renewable energy will ebb and flow, just as, in the past, interest in fostering sectoral or regional economic development has ebbed and flowed. What remains, what is constant, is the need to protect consumers from the abuse of monopoly power. When the ability to do so is threatened, the public interest is not served.

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1. *Northwestern Utilities Ltd. et al. v. City of Edmonton,* [1929] S.C.R. 186 at 193.
2. *Toronto Hydro-Electric System Limited v. Ontario Energy Board*, 2010 ONCA 284 at p. 21 (the "THESL Decision").
3. *Ontario Energy Board Act*, *1998,* S.O. 1998, C. 15 Schedule B, s. 78.
4. THESL Decision, *supra,* p. 12.
5. *Toronto Hydro-Electric System Limited v. Ontario Energy Board et al.,* (2009) 252 O.A.C. 188, para. 17.
6. THESL Decision*, supra*, p. 12.
7. *Electricity Act, 1998,* S.O. 1998, C. 15, Schedule A, s. 25.35.
8. *Electricity Act, 1998,* S.O. 1998, C. 15, Schedule A, s. 25.36.
9. *Ontario Energy Board Act*, *1998,* S.O. 1998, C. 15 Schedule B, s. 70(2.1).
10. See, for example, *Attorney General of Canada v. Inuit Tapirisat of Canada*, [1980] 2 S.C.R. 735.
11. EB-2009-0397, "Filing Requirements: Distribution System Plans Filing Under Deemed Conditions of Licence", March 25, 2010.
12. EB-2009-0152, Report of the Board on "The Regulatory Treatment of Infrastructure Investment in Connection with the Rate-Regulated Activities of Distributors and Transmitters in Ontario", January 15, 2010.
13. EB-2009-0096, Decision with Reasons, April 9, 2010, at p. 33.
14. *Great Lakes Power Limited v. Ontario Energy Board,* 2010 ONCA 399, at 12.
15. *R. v. Conway*, 2010 SCC 22, at 77.
16. *Ontario Energy Board Act*, *1998* S.O. 1998, C. 15 Schedule B, Section 1.

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