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Corporate Governance for Regulated Natural Gas and Electricity Utilities

Report Prepared by
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for the Ontario Energy Board

FINAL REPORT

December 19, 2016

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1 INTRODUCTION

1.1 BACKGROUND

The Ontario Energy Board (OEB) has established a performance based regulatory framework focused on utilities achieving outcomes that deliver value to customers. Good corporate governance contributes to utility performance and is an indicator of a utility's capability to meet the expectations embedded in the OEB's Renewed Regulatory Framework. The OEB has announced that it is developing corporate governance guidance for all Ontario rate-regulated utilities: electricity distributors, electricity transmitters, Ontario Power Generation, and natural gas utilities. As stated in the OEB's letter of June 22, 2106, announcing this initiative:

> *The OEB believes that providing guidance on good corporate governance will contribute to:*
>
> - *Effectiveness of regulation*
> - *Achievement of the OEB's legislative objectives*
> - *Delivering the outcomes established in the Renewed Regulatory Framework*

Elenchus has been retained by the OEB to provide expert assistance in developing the guidance, the indicators of performance (monitoring), and an approach to ensure effective regulatory oversight (assessment). The authors of this report are Cynthia Chaplin (Elenchus), Marie Rounding (Elenchus and Gowling WLG), George Todd (Elenchus), and Paul Harricks (Gowling WLG). The views and recommendations in this report are those of the authors and do not represent the views of the OEB.

1.2 PURPOSE OF THE REPORT

The purpose of this report is to:

- Discuss the context for the OEB's past, current and future interest in utility corporate governance
- Present the fundamentals of good corporate governance
- Present Elenchus' recommendations for the OEB guidance, monitoring and assessment (including a *Draft* of the OEB guidance)

1.3 THE PROCESS

KPMG conducted initial research for the OEB in 2014-2015, including a jurisdictional review of corporate governance requirements by other energy regulators and securities and financial regulators.[1] KPMG also conducted a survey of corporate governance practices in Ontario amongst select electricity distributors.[2] Elenchus has used the KPMG research and reviewed KPMG's analysis and recommendations in preparing this report.

Elenchus has prepared this report based on the earlier work by KPMG, and the Elenchus team's expertise, experience and research. A draft of this report was prepared and released in June 2016. However, we did not engage with stakeholders in preparing the draft report. We believe that an important part of the process is to gain insights directly from stakeholders, and therefore after the draft report was released the OEB organized a number of stakeholder sessions so that Elenchus could engage stakeholders on the principles and recommendations contained in the draft report.[3] These were targeted stakeholder meetings to assist Elenchus; they were not part of a formal OEB policy consultation process.

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[1] *Review of Corporate Governance of Electricity Distributors*, KPMG for Ontario Energy Board, Final Report, April 29, 2015.

[2] This survey work included interviews with selected LDC directors, on an anonymous basis.

[3] A list of participants in the stakeholder sessions is included in Appendix 5.

Elenchus has reflected on the discussion and input gathered through the stakeholder sessions and has addressed the key themes in this final report. In key chapters of this report we summarize the stakeholder input and explain how it has informed our recommendations. We thank the stakeholders for their thoughtful and constructive input.[4]

1.4 STRUCTURE OF THE REPORT

The report contains the following chapters:

1. Introduction
2. The OEB and Utility Corporate Governance: explains the history of corporate governance considerations at the OEB, recent developments, and the OEB's objectives for utility corporate governance going forward.
3. Duties of Directors and Corporate Governance Principles: presents the high level principles of good corporate governance, including the duties of directors, the key areas of responsibility for boards, and the main tools boards use to fulfill their responsibilities.
4. Select Case Law: discusses the key court cases involving corporate governance which are particularly relevant for regulated utilities.
5. Best Practices: Regulatory and Other Guidance: identifies the main sources for guidance on corporate governance, including financial and securities regulators.
6. Ownership Structure and Corporate Governance: describes the ownership structures for Ontario's natural gas and electricity utilities and discusses the impact on corporate governance issues.
7. Guidance: presents Elenchus' recommendations for the OEB guidance.
8. Monitoring: presents Elenchus' recommendations for monitoring utility corporate governance practices.

[4] A list of participants in the Stakeholder sessions is contained in Appendix 6.

9. Assessment: presents Elenchus' recommendations for assessing utility corporate governance practices.

We begin the report with a discussion of the OEB's regulatory framework and its relationship to corporate governance.

2 THE OEB AND UTILITY CORPORATE GOVERNANCE

This chapter lays out the history of corporate governance considerations by the OEB, identifies recent developments in utility corporate governance in Ontario, and describes the relationship between the OEB's regulatory framework and utility corporate governance.

2.1 HISTORY OF CORPORATE GOVERNANCE ISSUES AT THE OEB

The OEB's interest in utility corporate governance is not new. The OEB has had involvement in utility corporate governance issues in the past. For example, the OEB has imposed direct requirements on utility boards of directors through the Affiliate Relationships Codes. Under those codes, a minimum of 1/3 of corporate directors must be independent of any affiliate.[5] The OEB has also taken more direct action in response to a demonstrated need. In a case involving Toronto Hydro Electric System, the OEB determined that it was appropriate to require that a majority of the independent directors approve any dividend payment. This condition arose from the OEB's conclusion that dividends were being paid despite evidence of underinvestment in the system. (See Chapter 4 for a discussion of the court decision related to this case.)

The OEB has also reviewed corporate governance in the course of rate hearings. For example, when utilities propose significant investments and/or large rate increases, parties often probe what the board of directors knew about a proposal (the risks, costs/benefits, impacts on ratepayers, alternatives) and when they knew it.

[5] *Affiliate Relationships Code for Electricity Distributors and Transmitters*, March 15, 2010, section 2.1.2.

2.2 Recent Developments in Utility Corporate Governance in Ontario

There has been growing interest in corporate governance around the world and across Canada. This attention has also arisen in the Ontario utility sector. The Ontario Distribution Sector Review Panel was asked to provide expert advice to the government on how to improve efficiencies in the electricity distribution sector with the aim of reducing costs for customers. The Panel's recommendations were focused on greater consolidation, including recommendations in the area of corporate governance:

> *Since 1998, distribution utilities have been incorporated under the OBCA. The Panel feels it is time to treat the province's LDCs as the commercial enterprises they are; this will require municipal shareholders to adopt best practices in the stewardship of the LDC assets in order to ensure strong operating performance.*[6]

The Distribution Sector Review Panel recommended a process of distributor consolidation leading to a set of regional electricity distributors, with associated recommendations regarding corporate governance:

> *Given the importance of electricity distribution to the province's economy, it is important that the Boards of Directors of the regional distributors display a high standard of corporate governance. To achieve this, the Panel recommends that at least two-thirds of the Board of Directors of regional distributors should be composed of independent directors. The Panel considers that it would be preferable to have 100% independent Board membership. This has worked with the merged utility of Bluewater Power Distribution, and would help to overcome conflicting local priorities.*

[6] *Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First*, Report of the Ontario Distribution Sector Review Panel, December 2012, p. 37.

> *The Boards should be adequately sized to have directors with an appropriate range of skills and experience, and be populated on the basis of directors' qualifications to meet the management and oversight requirements of an electricity distribution utility. Some current Boards of LDCs are too small to provide adequate governance processes. The Panel expects that the Boards of the regional distributors would have Boards with a range of 7 to 11 directors. Regional distributors should also encourage their Board members to acquire proper training in the areas of governance and the roles of Boards.*[7]

New provisions in the *OEB Act* have also increased the focus on utility corporate governance. The *OEB Act* already contained corporate governance provisions which were applicable to the officers and directors of retailers and marketers. Under Bill 112, which has now been implemented, those provisions have been extended to the officers and directors of distributors and transmitters and unit sub-meter providers. These provisions state:

> *Every officer and director of the corporation must:*
>
> - *Exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.*
> - *Take such measures as necessary to ensure that the corporation complies with all requirements under the OEB Act, the Electricity Act and the Energy Consumer Protection Act.*[8]

As discussed in more detail in Chapter 3, legislation and case law clearly establish these duties. However, by enshrining these provisions explicitly in the *OEB Act*, the government has signalled its view of the importance of good corporate governance.

[7] Ibid., p. 38.

[8] Ontario Energy Board Act, 1998, s. 125.2.

This attention to utility corporate governance through the legislation complements the evolution of the OEB's interest in the subject. Whereas historically the OEB considered corporate governance in specific situations (e.g. affiliate relationships), the OEB is now considering utility corporate governance at a systemic level, and in particular how good corporate governance can facilitate the achievement of the OEB's regulatory mandate.

2.3 THE EVOLVING OEB REGULATORY FRAMEWORK AND CORPORATE GOVERNANCE

The OEB entered a new phase of its regulatory approach with the introduction of the Renewed Regulatory Framework for Electricity (RRFE) in 2012.[9] At its heart, the RRFE is about utility performance and delivering better value to customers. Past regulatory reviews focused on inputs and the cost to provide those inputs and whether the cost was justified. The RRFE approach focusses on the outputs or outcomes – what is delivered and the underlying strategies and plans to support the cost.

Although the OEB's RRFE Report explicitly applies to electricity distributors, the OEB has proceeded to implement the principles and processes of the RRFE more broadly. For example, in the most recent amendments to the filing requirements for transmission rate applications the OEB has incorporated the most significant components of RRFE, including rate options (Custom IR and Revenue Cap IR), transmission system plans, customer engagement, scorecards and benchmarking.[10] Natural gas utilities have adapted the principles of Custom IR in order to craft their own proposals. In March, the OEB announced that it would update its filing requirements for natural gas rate applications to incorporate the key principles of the RRFE.[11] In October 2016, the OEB

[9] *Report of the Board - Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach*, Ontario Energy Board, October 18, 2012.

[10] *Amended Filing Requirements for Transmission Applications*, cover letter from the OEB accompanying revisions to Chapter 1 and Chapter 2 of the Filing Requirements, February 11, 2016.

[11] *Filing Requirements for Natural Gas Distributor Rate Applications OEB File No. EB-2016-0033*, letter from the OEB, March 7, 2016.

released its *Handbook for Utility Rate Applications*, which outlines how the RRFE will be applied to all rate regulated utilities going forward.[12] Ontario Power Generation has filed incentive ratemaking proposals for nuclear and hydroelectric payments. It is clear that the objectives, principles and tools of the RRFE will have broad application in the Ontario regulated energy sector.

The importance of utility corporate governance and the linkage to the OEB's objectives has also been articulated by the Chair, Rosemarie Leclair:

> *A third key component of our performance based approach is good corporate governance… As the Board moves from a more prescriptive approach to regulation toward a more principled performance based approach to regulation…there must be a greater reliance on robust governance and due diligence processes within the regulated organization.*[13]

The Chair went on to explain what that would mean in practice:

> *Historically in utility rate applications, we at the OEB have looked at details, the line items, if you will, of utility cost components …things like headcount, and rates of pay… Under the new framework, we will be much more interested in understanding the unit costs to deliver a program, how decisions are made, and ensuring that those overall costs are competitive…we will care about the philosophy around how compensation is established and its relationship to utility performance…rather than the details as to how much individual employees are paid.*[14]

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[12] *Handbook for Utility Rate Applications*, October 13, 2016.

[13] *Performance based regulation seen through the customers' lens*, Remarks for the Ontario Energy Association, Energy Conference, Toronto, September 11, 2013.

[14] *Performance based regulation seen through the customers' lens*, Remarks for the Ontario Energy Association, Energy Conference, Toronto, September 11, 2013.

In the cover letter for the filing requirement amendments in 2013, the OEB again identified the link between good corporate governance and objectives of the RRFE:

> *Achievement of the desired outcomes is facilitated in large part by robust and effective corporate governance. The Board sees effective corporate governance as an important indicator of the likely success of a distributor's plans.*[15]

As an initial step, the OEB instituted filing requirements around corporate governance practices.[16]

The role of corporate governance within the regulatory framework is evolving. The OEB is working to advance a consumer-centric regulatory framework which brings together better customer engagement and better planning, better outcomes for customers and better utility performance. The OEB is also working to achieve these goals with efficient and effective regulatory processes. In many ways good corporate governance and effective economic regulation are aligned. Both focus on strategic objectives, ensuring strong processes, monitoring results, managing risk and taking corrective action when required. The OEB has signalled for some time the importance of good governance in the overall success of the Renewed Regulatory Framework. In Elenchus' view, the OEB could be a leader amongst energy regulators in this area by harnessing the strength of good corporate governance as a tool to advance its regulatory objectives.

The OEB has announced that it will develop guidance on utility corporate governance. This guidance will identify best practices, with particular attention and/or specific guidance on issues of particular relevance to utilities in the Ontario natural gas and electricity sectors. Importantly, this guidance will not set mandatory requirements. It will set out the OEB's perspective on the qualities and characteristics of good corporate

[15] *Update to Chapters 1, 2 and 3 of the Filing Requirements for Electricity Distribution Rate Applications*, cover letter from the OEB, July 17, 2013.

[16] These filing requirements are set out in Appendix 4.

governance by Ontario's rate-regulated utilities, which utilities may use as guidance as they work to continuously improve their corporate governance.

2.4 OEB's Objectives for Utility Corporate Governance

The OEB has identified a number of objectives for its guidance on corporate governance. Based on the OEB's letter announcing this initiative, Elenchus understands that the OEB seeks to:

- *Contribute to the effectiveness of the OEB's regulation:* The OEB will consider the quality of a utility's corporate governance when assessing utility performance and reviewing utility applications.
- *Facilitate achievement of the OEB's legislative objectives*: The OEB has a broad range of statutory objectives, including protecting the interests of consumers, facilitating economic efficiency, and facilitating a financially viable sector. The full list of statutory objectives is set out in Appendix 2.
- *Facilitate achievement of the four performance outcomes under the Renewed Regulatory Framework:* The RRFE is focused on delivering improved outcomes for customers in four areas: customer focus, operational effectiveness, public policy responsiveness, and financial performance.

In the next chapter we present the fundamentals of corporate governance through a discussion of the duties of directors and the principles that underpin good corporate governance.

3 Duties of Directors and Corporate Governance Principles

This chapter sets out at a high level the duties of directors and the key principles of good corporate governance. This discussion is not intended to be detailed or comprehensive; the intention is to set the context for the balance of the report and the *Draft Guidance*. In setting out these principles, we draw on some of the key sources for guidance in corporate governance. These key sources are discussed further in Chapter 5. We also draw on legislation.

The G20/OECD[17] *Principles of Corporate Governance* defines corporate governance in terms of relationships, structure and process:

> *Corporate governance involves a set of relationships between a company's management, its board, its shareholder and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.*[18]

Corporate governance itself is a clear concept which is widely understood, but what is *good* corporate governance? Good corporate governance is the combination of strong structure, clear policies, and robust processes. However, these elements alone are not sufficient. The Office of the Superintendent for Financial Institutions (OSFI) has pointed out the other key component: "Effective corporate governance is not only the result of 'hard' structural elements, but also 'soft' behavioural factors driven by the dedicated directors and management performing faithfully their duty of care to the institution."[19]

[17] The Organisation for Economic Co-operation and Development

[18] G20/OECD Principles of Corporate Governance, 2015, p. 9.

[19] OSFI, Guidance, p. 2.

The structure, policies and processes provide the foundation; the characteristics and behaviours of the directors, officers, and shareholders determine whether the governance is effective. Directors must have a clear understanding of their role, possess the skills necessary for the role, and be committed to fulfilling the role effectively. ***Good corporate governance is the effective independent oversight of a corporation by diligent and skilled directors, using robust processes to ensure accountability, fairness and transparency in a corporation's relationship with all of its stakeholders.***

Good corporate governance has many benefits. Corporations with effective corporate governance will be better run than those with weak corporate governance, with better results across a range of metrics, including risk management, operating performance, and earnings. Good corporate governance can reduce business risk. Strong corporate governance also instills confidence in stakeholders. For example, the G20/OECD explains the benefits in terms of access to capital:

> *. . . good corporate governance will reassure shareholders and other stakeholders that their rights are protected and make it possible for corporations to decrease the cost of capital and to facilitate their access to the capital market.*[20]

Just as good corporate governance can instill confidence in shareholders and investors, it can increase the confidence of other stakeholders, including customers and regulators. If the OEB can be confident in the corporate governance of the utilities it regulates, then it can have greater confidence in the quality of utility planning, investment and operations.

[20] G20/OECD Principles, p. 10.

The impacts of poor corporate governance are often significant. Director education programs draw on a wealth of case studies where poor results, and even disastrous outcomes, have had poor corporate governance at their root.

Good corporate governance is therefore important for the financial and operational health of the corporation on an ongoing basis, and it is also an important indicator of future performance which increases the confidence of the key stakeholders.

We now turn to the fundamental duties of directors, followed by a description of the board's key activities and the main tools available to boards.

3.1 DIRECTOR DUTIES

Each director on a corporate board has two fundamental duties: a fiduciary duty and a duty of care. These duties are grounded in legislation and common law. The most relevant legislation for our purposes is the *Ontario Business Corporations Act* (*OBCA*). (Important case law related to director duties is addressed in the next chapter.)

A director's fiduciary duty and duty of care is set out in section 134 of the *OBCA*:

> *134.(1) Every director and officer of a corporation in exercising his or her powers and discharging his or her duties to the corporation shall,*
>
> > *(a) act honestly and in good faith with a view to the best interests of the corporation; and*
> >
> > *(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances*

It is worth emphasizing that each director must act in the best interests of the ***corporation (fiduciary duty)***, and must exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances (***duty of care***). In order to fulfil the duty of care, a director must devote reasonable time and attention to the affairs of the corporation and exercise informed business judgment. Determining what is in the best interests of the corporation is a function of business judgment exercised in specific fact situations. While the best interests of the corporation are often aligned with the interests of the shareholders, this is not always the case. If the interests of the shareholders and corporation conflict, the duty of each director is clear: it is to the corporation and not to the shareholders. In the case of a regulated utility, that duty is to the long-term interests of the corporation because of the ongoing, long-term nature of the business and the fact that it is a monopoly.

Failure to fulfill these duties can lead to personal liability for the directors. Where a board of directors can demonstrate that it has met the duty of care, courts will generally show deference to the conclusion reached by the board in its decision-making process. Directors are not expected to have detailed firsthand knowledge of the corporation or to be technical experts in various fields. Therefore directors may rely on the information and financial statements provided by management and the opinions and advice received from external experts. These legal concepts are known as the due diligence defence and the business judgment rule.

Due diligence involves the thorough review and investigation which directors undertake before reaching a decision. Although the liability provisions vary across statutes, directors can generally establish a due diligence defence against personal liability if they can demonstrate that they exercised due diligence, which may include relying *in good faith*[21] on financial statements, information provided by management, and/or advice provided by qualified external advisors.[22]

[21] *In good faith* means that the director has considered whether the information is reasonable, has questioned the information and analysis, and has no reason to doubt the honesty or integrity of the people providing the information or advice.

[22] It is worth noting that there is no due diligence defence for liability for employee wages.

Under the business judgment rule, the courts will not substitute their business judgment for that of the directors if the directors can demonstrate that the decision was made honestly, prudently, in good faith, and on reasonable grounds. Importantly, both of these principles rely on the directors' ability to demonstrate that they have fulfilled their duty of care and fiduciary duty; in other words the process for decision-making is more important than the result of the decision. Therefore, it will be important to have appropriate documentation of the process used.

Although decisions are taken by the board as a whole, each individual director must fulfill his/her fiduciary duty and duty of care. It is therefore particularly important for directors to consider any potential conflicts of interest (real or perceived) which might impair the director's ability to act independently in the decision-making process. Where directors are found to have not fulfilled their duties, they may be found personally liable.

Directors also have a variety of other duties and face a number of potential liabilities. Health and safety, employment, and environmental obligations are particularly important for the directors of utilities. However, there are dozens of federal and provincial statutes which must be considered, covering a very broad range of issues. We do not discuss these obligations in this report. Readers are encouraged to review the various sources of information, and/or seek legal advice regarding these matters.[23]

3.2 PRINCIPLES OF GOOD CORPORATE GOVERNANCE

The principles of good corporate governance include independence, transparency and accountability. These principles are demonstrated through *what* the board of directors does, and *how well* the board of directors functions.

The board of directors has stewardship responsibilities in four key areas:

[23] See for example, *Directors' Responsibilities in Canada*, Osler, Hoskin & Harcourt LLP and Institute of Corporate Directors, October 2014. (See Appendix for link.)

- **Strategy**: The board is responsible for setting the strategic direction for the corporation.
- **Risk**: The board is responsible to setting the risk appetite for the corporation and for ensuring that risks are being identified, quantified, managed and mitigated.
- **Financial and Operational Performance**: The board is responsible for monitoring performance against the corporation's objectives and taking corrective action where needed.
- **Assessment/Succession**: The board is responsible for selecting and assessing the CEO, and for setting the CEO compensation. It is also responsible for approving CEO recommendations with regard to senior management assessment and compensation. The board is also responsible for ensuring the effective succession process for the CEO and senior management.

The board of directors has a set of tools to help the directors meet their duties and responsibilities in the key areas set out above:

- **Mandate and charters**: Mandates and charters articulate the roles and responsibilities of the board and each committee.
- **Codes**: Codes establish the expectations for conduct by directors, executives and employees in a variety of areas, including ethics, business conduct and conflict of interest.
- **Processes**: Robust processes facilitate decision-making through effective due diligence, including access to external expertise. Effective processes are particularly important in areas such as strategic planning; risk oversight; financial oversight; director selection, orientation, education and assessment; CEO and senior executive succession, etc.
- **Communication**: Information protocols facilitate the effective flow of information between management and the board. Disclosure protocols facilitate effective flow of information to stakeholders (including regulators).

- **Assessment**: Regular assessments of individual directors and the board as a whole allow for the measurement of board and director effectiveness and the identification of areas for further development.

Boards can use these tools in a wide variety of ways to fulfill their duties in the key areas of corporate governance. The more rigorous the process is, the stronger the governance framework will be. These process tools can facilitate good corporate governance by providing clarity to roles and responsibilities, thereby strengthening decision-making. Each board must determine the practices which best meet its needs in the particular circumstances facing the corporation.

The quality of the processes and practices alone will not ensure good corporate governance however. Strong processes and practices must be matched with skilled and committed directors. The directors must have the necessary skills, including ongoing education and development opportunities. Directors must exercise good business judgment, bearing in mind their fiduciary duty and duty of care. And directors must be diligent in their work. Diligence is not passive; it requires active questioning and thoughtful discussion. To be effective, directors must insist on high quality information, from management and from external experts where warranted. Directors, and the board as a whole, must exercise independent judgment, which is informed by the interests of stakeholders, but not directed by any individual stakeholder (including a shareholder).

Board Chairs have a particularly important role in leading the board of directors, setting the overall tone, and facilitating active and productive discussions. The Chair ensures active engagement by all directors and a full airing of views. The Chair also ensures that the relationship between the board and the CEO and executives remains productive.

Good corporate governance is transparent and accountable. The roles and responsibilities, and practices and processes should be transparent, so that stakeholders can have confidence in the quality of the governance. The board of directors should also be accountable through the regular assessment of its performance.

Corporate governance performance can be thought of as a continuum running from weak governance to strong governance. Each utility will be positioned at some point along that continuum. Regardless of a utility's position, improvements can be made. A board's willingness to objectively assess and improve its practices is itself a sign of good governance. High performing boards maintain a culture of continuous improvement through ongoing improvements to the quality and effectiveness of their governance practices in line with changes in the business and regulatory environment and the evolution of corporate governance more broadly.

Practices which are particularly strong are recognized as "best practices". An extensive literature is available on best practices in corporate governance. Some of these resources are set out in Appendix 4. Financial and securities regulators also provide guidance which set expectations for corporate governance, including some mandatory requirements. These topics are addressed in Chapter 5.

The duties of directors, although established through a variety of legislation, have been interpreted and clarified through many decades of court decisions. The key decisions which are particularly relevant for Ontario's natural gas and electricity utilities are discussed in the next chapter.

4 Select Case Law

This chapter focusses discussion on some key court cases involving corporate governance which are particularly relevant for regulated utilities. This case law establishes the foundation for some of the key principles for corporate governance generally. One of the cases (*Toronto Hydro-Electric System v. Ontario Energy Board*) addresses the OEB's jurisdiction in this area. We discuss the following cases:

- *Peoples Department Stores Inc. (Trustee of) v. Wise*
- *BCE Inc. v. 1976 Debentureholders*
- *Toronto Hydro-Electric System v. Ontario Energy Board*
- *820099 Ontario Inc. v. Harold E. Ballard Ltd*.
- *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.*
- *Brant Investments Ltd. v. KeepRite Inc.*

4.1 Peoples Department Stores Inc. (Trustee of) v. Wise (Supreme Court of Canada, 2004)

The fiduciary duty and duty of care are defined in legislation, but the standards which will apply to these duties have been described in more detail in the *Peoples Department Stores* case.[24]

The case involved the bankruptcy of Wise and its subsidiary Peoples Department Stores. The trustee for Peoples alleged that the Wise brothers (the only directors on Peoples' board and the majority owners of Wise) failed to meet their duties as directors. Wise had recently purchased Peoples, but the two companies were required to remain as separate legal entities until the full purchase price was paid. The companies had instituted a shared inventory system in an attempt to address the severe dysfunction

[24] *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461, 2004 SCC 68.

which had resulted. The companies were subsequently declared bankrupt. The trustee for Peoples claimed that the Wise brothers had favoured Wise over Peoples, to the detriment of Peoples' creditors and in breach of their fiduciary duty and duty of care.
The appeal was dismissed. The court found that the Wise brothers had not breached their duties, and set out specific standards for both the fiduciary duty and the duty of care.

In describing the standard for fiduciary duty, the Court identified strict and specific expectations for director behaviour and performance:

> *The statutory fiduciary duty requires directors and officers to act honestly and in good faith vis-à-vis the corporation. They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. They must maintain the confidentiality of information they acquire by virtue of their position. Directors and officers must serve the corporation selflessly, honestly and loyally.*[25]

In describing the standard for the duty of care, the Court noted the requirement to act prudently and to be reasonably informed. The decision was also clear that while courts would not second-guess directors' business expertise, they would examine and determine whether sufficient prudence and diligence were applied:

> *Directors and officers will not be held to be in breach of the duty of care … if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that breached the duty of care, it is worth*

[25] Ibid. para. 35.

> *repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.*[26]

This decision provides a clear articulation of the standards to which the courts will hold directors when assessing whether they have met their statutory duties. The Court also found that when determining the best interests of the corporation, it may be appropriate for directors to consider the interests of shareholders, creditors, employees, suppliers and others. This is discussed further in the next section.

4.2 BCE Inc. v. 1976 Debentureholders (Supreme Court of Canada, 2008)

Although it is broadly understood that directors must act in the best interests of the corporation, it has sometimes been said that this is the same as acting in the best interests of shareholders. This is not correct. In determining whether a decision is in the best interests of the corporation, directors must consider the impact of the decision on shareholders and on other stakeholders. This principle was articulated in *BCE Inc. v. 1976 Debentureholders*, a Supreme Court of Canada decision.[27]

The case involved the leveraged buy-out of BCE, an arrangement valued at $52 billion. A group of debenture holders opposed the arrangement on the basis that it would diminish the value of their debentures.

[26] Ibid. para. 67.

[27] *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69.

The Supreme Court reinforced that the directors have two duties: a fiduciary duty and a duty of care. The case involved the fiduciary duty. The debenture holders claimed (among others things) that their interests had been disregarded or were not adequately taken into account. The Court refers to its earlier decision in *Peoples Department Stores* to establish the appropriateness of considering the interests of shareholders and other stakeholders as part of the directors' fiduciary duty:

> *In Peoples Department Stores, this Court found that although directors must consider the best interests of the corporation, it may be appropriate, although not mandatory, to consider the impact of corporate decisions on shareholders or particular groups of stakeholders. As stated by Major and Deschamps JJ., at para. 42:*
>
> > *We accept as an accurate statement of law that in determining whether they are acting with a view to the best interest of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.*[28]

The decision in *BCE* examines this concept further and concludes that a director's fiduciary duty includes a duty to consider the interests of all stakeholders, not just shareholders, when considering the best interests of the corporation:

> *The cases on oppression, taken as a whole, confirm that the duty of the directors to act in the best interests of the corporation comprehends a duty to treat individual stakeholders affected by corporate actions equitably and fairly. There are not absolute rules. In each case, the question is whether, in all the circumstances, the directors acted in the best interests of the corporation, having regard to all relevant considerations, including, but not confined to, the need to*

[28] BCE, para. 39.

> *treat affected stakeholders in a fair manner, commensurate with the corporation's duties as a responsible corporate citizen.*[29]

For regulated utilities, the implication is clear that when decisions are taken, directors have a duty to decide in the best interests of the corporation, but must do so with due consideration to the interests of all affected stakeholders and the impact of the decision on those stakeholders.

4.3 TORONTO HYDRO-ELECTRIC SYSTEM V. ONTARIO ENERGY BOARD (ONTARIO COURT OF APPEAL, 2010)

Where *BCE* establishes that directors must consider the interests of all relevant stakeholders as part of their fiduciary duty, the decision by the Ontario Court of Appeal in *Toronto Hydro-Electric System v. Ontario Energy Board* states that a regulated utility must balance the interests of customers and shareholders. The decision also confirms the OEB's jurisdiction in areas related to corporate governance matters.

In a rate case involving Toronto Hydro-Electric System (THESL), the OEB included in its order a condition requiring that any dividend payment be approved by a majority of the independent directors. THESL appealed the decision, arguing that the OEB did not have the jurisdiction to impose such a condition. The appeal was successful at Divisional Court, but was overturned by the Court of Appeal.[30] The Court of Appeal decision is important in two areas: the OEB's jurisdiction in corporate governance, and the obligations of the utility's directors and officers.

In the words of the court, the issue before it was "whether the OEB had the ability, as part of its 2006 rate decision, to require THESL to obtain the approval of a majority of its

[29] BCE, para. 82

[30] *Toronto Hydro-Electric System Limited v. Ontario Energy Board*, 2010 OCA 284 (April 20, 2010)

independent directors before declaring any dividends."[31] The Court found that the OEB did have the jurisdiction to make such a condition, noting associated case law and the legislation: "Thus, the legislation reflects a clear intent by legislators to use both a subjective and open-ended grant of power to enable the OEB to engage in the impugned inquiry in the course of rate setting."[32]

Further, the Court determined that the OEB decision was reasonable. As part of its findings, the Court stated that there was an important distinction between a private corporation and a publicly regulated corporation (although both are subject to the *Business Corporations Act*):

> *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 interest of the shareholders) while a regulated utility must operate in a manner that balances the interest 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 ratepayers.*[33]

The Court also commented on the intersection between corporate law and the OEB's regulatory mandate in deciding what standard of review was appropriate:

> *Corporate law principles will often be engaged when making decisions in respect of regulated corporations. It is the regulator's duty to use its expertise to apply*

[31] Ibid., para. 11.

[32] Ibid. para. 29.

[33] Ibid. para. 50.

> *corporate law principles within the context of its objectives; this implies a reasonableness standard.*[34]

The Court found that the OEB had not contravened corporate law. The full board would still be required to approve a dividend. The OEB's condition did not replace the authority of the board; it provided an additional check to balance the interests of shareholders and customers.

The decision in *THESL* articulates an important standard for regulated utility directors and officers, namely that the utility must balance the interests of shareholders and ratepayers. Further, the decision confirms the OEB's authority to act, including in areas of corporate law and corporate governance, where it determines that doing so is necessary to protect the interests of consumers.

4.4 820099 Ontario Inc. v. Harold E. Ballard Ltd.

In Ontario, most electricity distribution utilities are owned by one or more municipalities. The gas utilities are subsidiaries of larger multinational investor-owned corporations. OPG is owned by the Province of Ontario, and Hydro One is majority owned by the Province of Ontario, although the intention is to issue shares such that the province's position will be reduced to 40%. As a result, essentially all of the regulated utilities in Ontario are closely held.[35] In these circumstances, the directors are often not only elected, but also recruited and directly nominated by the shareholder(s). In the case of electricity distributors owned by multiple shareholders, directors are often nominated separately by each owner in proportion to its respective ownership interest.

[34] Ibid. para. 41.

[35] Eventually Hydro One will not be closely held. The legislation contemplates that 60% of the equity in the corporation will be sold to investors, and no one investor (other than the Province) will be allowed to hold more than 10%.

A director may have been nominated directly by a shareholder, but the director's duty lies with the best interests of the corporation as a whole, not to the nominating shareholder. This principle was articulated in a court decision involving Harold Ballard's company: "The nominee director cannot be a 'Yes Man'; he must be an analytical person who can say 'Yes' or 'No' as the occasion requires (or to put it another way, as the corporation requires)."[36]

In the circumstances where the interests of the corporation and the shareholders are aligned then no difficulty arises, although there is still the duty to consider the interests of other stakeholders. However, where the interests of the appointing shareholder differ from the interests of the corporation, a real challenge is presented. The Court readily acknowledged the difficulty for nominee directors:

> *It may well be that the corporate life of a nominee director who votes against the interest of his "appointing" shareholder will be neither happy nor long. However, the role that any director must play (whether or not a nominee director) is that he must act in the best interests of the corporation…*[37]

This case has direct application for Ontario utilities. Although a director may have been nominated by a shareholder, the shareholder may not control how the director acts, and the director may not base his/her decisions solely – or even primarily – on the best interests of that shareholder. This situation can be particularly challenging where the municipal shareholder has nominated a municipal councillor as director. In these circumstances, there are likely to be dual loyalties, with a significant potential for conflict of interest between the councillor's duty as a director and the councillor's duty as a member of the council of the municipality which is the shareholder. We discuss this issue further in Chapter 6.

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[36] *820099 Ontario Inc. v. Harold E. Ballard Ltd*., [1991] O.J. No. 266 (Gen. Div.), aff'd by [1991] O.J. No. 1082 (Div. Ct.)

[37] *820099 Ontario Inc. v. Harold E. Ballard Ltd*., [1991] O.J. No. 266 (Gen. Div.), aff'd by [1991] O.J. No. 1082 (Div. Ct.)

The challenges facing municipal councillors in terms of divided loyalties are exacerbated where, as is often the case in the Ontario distribution sector, the distributor is ultimately controlled by several shareholders including other municipalities. In such a structure, each municipality typically holds its investment in the distributor through a wholly-owned holding company and the councillor may serve on the board of both the holding company and the distributor. In the councillor's capacity as a director of the holding company he or she has only one shareholder's interests to consider (the municipality that elected him or her) but in the councillor's capacity as a director of the distributor, he or she must now take into account the interests of the other municipal shareholders too, as well as the other stakeholders that we have discussed.

4.5 PWA Corp. v. Gemini Group Automated Distribution Systems Inc. (Ontario Court of Appeal, 1993)

The position of nominee directors is often complex. This is particularly so when dealing with confidential information and the challenge of dual loyalties. This issue was addressed in *PWA Corp. v. Gemini Group Automated Distribution Systems Inc*.[38]

The case involved Gemini, a partnership formed by PWA, Air Canada and a third party, to operate a joint reservation system. Gemini's board consisted of nominees from the partners. PWA began secret negotiations with another party which would have eliminated its need for Gemini, thereby affecting a vital aspect of Gemini's business. PWA's nominee directors on the Gemini board (who were involved in the negotiations) never informed the board of these developments.

The Court found that the directors were under no duty to disclose strategies that would disadvantage their respective airlines. However, the PWA nominee directors breached their fiduciary duty to Gemini by not disclosing information they had which affected "a vital aspect of its business."

[38] *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.,* [1993] O.J. No. 1793 (C.A.).

This case demonstrates the care which directors must apply in situations where they hold multiple directorships or other positions which may create potentially conflicting interests. Wherever possible, steps should be taken to avoid such conflicts before they arise.

4.6 BRANT INVESTMENTS LTD. V. KEEPRITE INC., 1991 (ONTARIO COURT OF APPEAL)

As discussed previously, the court will not second-guess a board's business judgment, but will examine and assess the process the board used. The *KeepRite* decision is a good example of how the Court will examine the process used to reach a decision as part of its analysis. The decision also demonstrates the value of independent directors within the corporate governance framework.[39]

The case involved the acquisition of assets from a subsidiary. Because the transaction was non-arm's length, an independent committee of the board was struck. The committee examined the proposed transaction over the course of five meetings and concluded that the transaction was fair to the corporation, including the minority shareholders. The committee reported to the board, and the board approved the transaction. The minority shareholders challenged the decision.

The Court clearly described the role of the Court in reviewing the process used, not the business decision itself:

> *There can be no doubt that … the trial judge is required to consider the nature of the impugned acts and the method in which they were carried out. That does not mean that the trial judge should substitute his own business judgment for that of managers, directors, or a committee such as the one involved in assessing this transaction. Indeed, it would generally be impossible for him to do so, regardless*

[39] Brant Investments Ltd. v. KeepRite Inc., 1991 CANLII 2705 (ON CA)

> *of the amount of evidence before him. … In short, he does not know enough to make the business decision required. That does not mean that he is not well equipped to make an objective assessment of the very factors which s. 234* [provisions related to oppression] *requires him to assess.*

The decision demonstrates the application of the business judgment rule and, in particular, shows the value of independent directors, and committees of independent directors, in establishing a process which is demonstrably designed to achieve the best interests of the corporation, rather than a particular shareholder. However, the process used by the committee will also be part of the court's assessment. In *Repap* the court intervened and set aside a board decision because the court found that the process was flawed, even though a committee of independent directors was used.

These cases have particular relevance for utilities when they are considering non-arm's length transactions which have the potential to adversely affect minority shareholders or any other stakeholders (including customers) whose interests the board must consider. In these circumstances an independent committee and a strong process for evaluation will be valuable corporate governance tools.

4.7 CONCLUSION

Directors must act in the best interests of the corporation, and in determining the best interests of the corporation they must consider the interests of all relevant stakeholders, including customers. A director's duty does not lie with acting in the best interests of any particular stakeholder (including the shareholder that nominated her/him); the director must always act in the best interests of the corporation as a whole.

In some situations the best interests of the corporation and the best interests of shareholders will be aligned; other times they will not. For example, their interests may diverge over the amount and timing of dividends, depending upon the impact on the corporation and the achievement of its business objectives. Similarly, in some situations the best interests of the shareholders and the best interests of the customers will be aligned, and other times they will not. For example, their interests may not be aligned on issues such as the timing and magnitude of capital projects, or the pursuit of unregulated business activities within the utility. In those cases where the interests are not aligned, the utility's directors must nonetheless consider the interests of customers, weigh their interests against the interests of other stakeholders and act in the best interests of the corporation as a whole.

Although directors have the duty to consider the interests of stakeholders, including customers, the OEB cannot rely solely on the board of directors to ensure the OEB's mandate is fulfilled. Although directors have a duty to consider the interests of customers, they do not have duty to act in their best interest; they must remain loyal to the best interests of the corporation. The OEB, on the other hand, has a broad public interest mandate and an explicit objective to protect the interests of consumers.

The next chapter identifies some of the key sources for guidance on corporate governance principles and practices.

5 BEST PRACTICES: REGULATORY AND OTHER GUIDANCE

In this chapter we identify some of the key sources for guidance on corporate governance and best practices. These principles and best practices form the foundation of Elenchus' recommendations for the OEB guidance, and the complementary monitoring and assessment tools. For each of the sources, we draw attention to aspects which are particularly relevant to Ontario's regulated energy utilities.

5.1 G20/OECD

The OECD first published its *Principles of Corporate Governance* in 1999. They have become an international benchmark, recognized and adopted by organizations such as the Financial Stability Board and the World Bank. The *Principles of Corporate Governance* were reviewed in 2004 and then again in 2014/2015, and the latest review also included non-OECD G20 members. The revised G20/OECD *Principles of Corporate Governance,* published in 2015, aims to "provide a robust but flexible reference for policy makers and market participants to develop their own frameworks for corporate governance."[40]

Many of the G20/OECD principles relate to a jurisdiction's overall legal framework for corporate governance and are intended to assist policy makers to assess and strengthen the legal, regulatory, and institutional corporate governance framework. However certain key principles are addressed directly at the level of the individual corporation and its corporate governance, in particular disclosure and transparency (principle V) and the responsibilities of the board (principle VI). For example, under the principle of disclosure and transparency, the G20/OECD states that the following should be disclosed (amongst others):

[40] G20/OECD, Principles, p. 11.

- The board members, including qualifications, selection process, other directorships and whether they are considered independent
- Related party transactions
- Risk factors
- Issues regarding employees and other stakeholders
- Governance structures and policies

Under the responsibilities of the board, the G20/OECD identifies the following key functions:

- Reviewing and guiding corporate strategy, major plans of action, risk management policies and procedures, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
- Monitoring the effectiveness of the company's governance practices and making changes as needed.
- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
- Ensuring a formal and transparent board nomination and election process.
- Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards
- Overseeing the process of disclosure and communications.

The OECD has also published complementary *OECD Guidelines on Corporate Governance of State-Owned Enterprises*. First published in 2005, this document was also updated in 2015.[41] The OECD describes these guidelines as the "internationally agreed standard for how governments should exercise the state ownership function to avoid the pitfalls of both passive ownership and excessive state intervention."[42] As with the *G20/OECD Principles*, the *OECD Guidelines* are largely related to the overall legal, regulatory and institutional framework for state-owned enterprises, but also give specific attention to disclosure and the responsibilities of boards.

On the topic of disclosure, the *OECD Guidelines* state the "state-owned enterprises should observe high standards of transparency and be subject to the same high quality accounting, disclosure, compliance and auditing standards as listed companies."[43] On the topic of the responsibilities of the boards the *OECD Guidelines* state that "the boards of SOEs should have the necessary authority, competencies and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions."[44]

5.2 CANADIAN SECURITIES REGULATORS

In Canada, securities regulators have developed guidance on corporate governance best practices and associated disclosure requirements. In general, any company which issues debt or equity through the public markets (a reporting issuer) is subject to these instruments, and the associated disclosure requirements. Ontario's largest regulated utilities are already subject to these instruments, including Hydro One, Ontario Power Generation, Toronto Hydro, Enbridge Gas, and Union Gas. However, the reporting is often at the level of the parent company or holding company, not at the level of the

[41] *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, 2015 Edition,

[42] OECD *Guidelines*, p. 7.

[43] OECD *Guidelines*, p. 24.

[44] OECD Guidelines, p. 26.

regulated utility. The *Corporate Governance Guidelines (National Policy 58-201)* have been developed with the following objectives:

- To achieve a balance between protecting investors and fostering fair and efficient capital markets
- To be sensitive to the greater number of small companies
- To take account of corporate governance developments internationally
- To recognize the evolving nature of corporate governance

The guidelines identify a number of characteristics that every board should have as part of its corporate governance practices, including the following:

- Clear and comprehensive written mandate
- Majority independent directors
- Full orientation and ongoing education and development of directors
- Regular board and director assessments
- Written code of conduct and ethics (which address conflict of interest as well as other issues)
- Nominating committee of only independent directors, with a charter and a skills and competency-based selection process for selection
- Compensation committee of independent directors, with a charter

The guidelines are not mandatory. However, the *Disclosure of Corporate Governance Practices (National Instrument 58-101)* mirrors the guidelines and sets out the specific information which reporting issuers must disclose. (The OEB's filing requirements on corporate governance largely followed these securities disclosure requirements.)

Securities regulators have established separate requirements for audit committees. Audit committees are mandatory for reporting issuers, and there is a set of related requirements which go into considerable detail as to the roles and responsibilities of audit committees, including their composition, authority, and reporting obligations.[45]

These national guidelines and requirements provide guidance which is directly applicable to Ontario's regulated natural gas and electricity utilities and provides support for the OEB's initiative.

5.3 CANADIAN FINANCIAL INSTITUTIONS REGULATOR

The Office of the Superintendent of Financial Institutions Canada (OSFI) has also developed guidelines "to communicate OSFI's expectations with respect to corporate governance of federally-regulated financial institutions."[46] The OSFI Guideline explicitly acknowledges the limitations of guidance on structure, policies and controls in the absence of a strong governance culture:

> *Appropriate organizational structures, policies and other controls help promote, but do not ensure, good corporate governance. Governance lapses can still occur through undesirable behaviour and corporate values. Effective corporate governance is not only the result of "hard" structural elements, but also "soft" behavioural factors driven by dedicated directors and management performing faithfully their duty of care to the institution.*
>
> *What makes organizational structures and policies effective, in practice, are knowledgeable and competent individuals with a clear understanding of their role and a strong commitment to carrying out their respective responsibilities* [47]

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45 *National Instrument 52-110 Audit Committees* (see, for example, January 1, 2011 Unofficial Consolidation)

46 Office of the Superintendent of Financial Institutions (OSFI) *Guideline* (Corporate Governance, Sound Business and Financial Practices), January 2013.

47 OSFI Guideline, p. 2.

Although regulated utilities are not subject to the OSFI Guideline, it offers further insight into certain key areas, while reinforcing the principles and best practices articulated by other regulatory and governing bodies. It focusses on the role of the board of directors (and the distinction between its responsibilities and the responsibilities of senior management), risk governance, and the audit committee. Of particular interest to Ontario utilities is the discussion on Risk Appetite Framework which the corporation should develop and the board of directors should approve. This recognizes the importance of identifying and assessing risks and their impacts, and ensuring policies and controls to manage the risks effectively. The OSFI Guideline succinctly explains the function of the board:

> *The Board should understand the decisions, plans and policies being undertaken by Senior Management and their potential impact on the FRFI* [Federally-Regulated Financial Institution]. *It should probe, question and seek assurances from Senior Management that these are consistent with the Board-approved strategy and risk appetite for the FRFI, and that the corresponding internal controls are sound and implemented in an effective manner. The Board should establish processes to periodically assess the assurances provided to it by Senior Management.*[48]

Although not directly applicable to Ontario energy utilities, the OSFI Guideline provides valuable and insightful guidance which can support the OEB's initiative.

5.4 OTHER SOURCES

Various provincial governments have produced guidance for how provincial agencies should be governed. These can provide useful guidance to government-owned corporations, including the municipally-owned electricity distributors. For example, Alberta has legislation which sets out the governance requirements for provincial

[48] OSFI Guideline, p. 4.

agencies.[49] British Columbia has a Crown Agencies Resource Office which is responsible for:

- Developing and providing policies and processing to enhance transparency and accountability of Crown corporations and other public sector organizations.
- Developing best practice guidelines and providing advice about mandate directives, service plans and annual reports.

In Ontario, a special advisor to the Minister of Government Services was appointed and was given the mandate to:

- Review the governance framework and accountability mechanisms of agencies
- Review ministry and central agency monitoring and evaluation practices
- Make recommendations for further improvements

The special advisor's 2010 report (the Burak Report) includes recommendations to strengthen board governance and accountability at provincial agencies.[50]

A variety of education and professional organizations also provide education, training and publications related to corporate governance best practices. In addition, a number of legal and consulting firms provide materials on corporate governance best practices, including articles and webinars. A selection of these resources is set out in Appendix 4. Examples include the Institute of Corporate Directors, The Directors College, the Chartered Professional Accounts of Canada (CPA), the Canadian Coalition for Good Governance (CCGG), and the Conference Board of Canada.

For example, the CCGG's *Building High Performance Boards* sets out expectations of shareholders for a well-governed, high performance board. CCGG generally uses these principles when it assesses the governance practices of Canadian public companies,

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[49] *Alberta Public Agencies Governance Act*, 2009.

[50] *Report of the Special Advisor on Agencies*, Rita Burak, December 20, 2010.

and it gathers specific examples of best practices in its annual Best Practices publication.

The breadth of resources available demonstrates that a wide variety of entities are interested in improving corporate governance and that utilities have access to an extensive body of research and advice. A number of resources are set out in Appendix 4.

5.5 CONCLUSION

There is a wide variety of sources for guidance and best practices in corporate governance. All of these are grounded in the same basic principles, and each is tailored to a particular focus of the entity producing the guidance. In developing the recommendations, Elenchus has built on the basic principles of good corporate governance and considered how the guidance should be tailored to the circumstances of Ontario's regulated utility sector, particularly the ownership structure of Ontario's utilities and the mandate and objectives of the OEB. These considerations of ownership structure are addressed in the next chapter.

6 OWNERSHIP STRUCTURE AND CORPORATE GOVERNANCE

This chapter describes the ownership structures of utilities in Ontario and discusses the most important characteristics that distinguish municipally and provincially-owned utilities from investor-owned utilities from a corporate governance perspective. These features will need to be considered as the OEB develops its guidance, along with its monitoring and assessment tools.

6.1 OWNERSHIP STRUCTURES

There are a variety of ownership structures in the natural gas and electricity utility sector in Ontario:

- **Electricity Distributors**: Almost all of Ontario's electricity distributors are municipally-owned. Many are owned by a single municipality, although a significant number are owned by two or more municipalities. Several utilities have outside investors, and some are entirely investor-owned.[51] The largest distributor, Hydro One, is majority owned by the Province. The Province has sold 30% of the shares on the public market, and intends to sell further tranches up to a total of 60%.

- **Electricity Transmitters**: Hydro One is also the province's largest transmitter (around 97%). It is also the majority owner of B2M, which is a partnership with Saugeen Ojibway Nation. Five Nations Energy Inc. is owned by a group of First Nations, and Canadian Niagara Power is investor-owned (Fortis). Great Lakes Power is also investor-owned (Brookfield), but it has agreed to sell its

[51] Corix Utilities has a 10% interest in Entegrus. Borealis has a 10% interest in Enersource. Fortis Ontario owns 100% of Algoma Power, Canadian Niagara, Cornwall Electric, and Eastern Ontario Power and a 10% interest in each of Westario, Grimsby, Rideau St. Lawrence.

transmission business to Hydro One.

- **Generators**: The largest generator, Ontario Power Generation, is owned by the Province. (Other generators do not have their rates regulated by the OEB.)

- **Natural Gas Distributors and Transmitters**: Ontario's two largest natural gas utilities are investor-owned through their parent corporations, both of which are publicly held companies. Enbridge Gas Distribution is owned by Enbridge Inc. and Union Gas Limited is owned by Spectra Energy. (Enbridge Inc. recently announced its plan to acquire Spectra Energy.) The third largest gas utility (Natural Resource Gas) is privately owned.

These various ownership structures can present specific corporate governance considerations.

6.2 CORPORATE GOVERNANCE CONSIDERATIONS

The challenges of corporate governance in state-owned corporations are widely recognized. The OECD identifies two particular governance challenges for state-owned entities (SOEs):

> *On the one hand, SOEs may suffer from undue hands-on and politically motivated ownership interference, leading to unclear lines of responsibility, a lack of accountability and efficiency losses in the corporate operations. On the other hand, a lack of any oversight due to totally passive or distant ownership by the state can weaken the incentives of SOEs and their staff to perform in the best interest of the enterprise and the general public who constitute its ultimate*

> *shareholders, and raise the likelihood of self-serving behaviour by corporate insiders.*[52]

In other words, challenges for corporate governance can arise from insufficient attention to governance on the one hand and undue interference in decision-making on the other.

Municipally-owned distributors are subject to the *OBCA*; however they were originally operated as public utility commissions under the *Public Utilities Act*. Members of the commissions were either elected directly or were appointed by the municipality. These entities have therefore undergone a significant transition to operate as for-profit corporations, including developing corporate governance structures and processes that are appropriate for such entities. KPMG reviewed the governance practices of a number of Ontario electricity distributors and found that distributors are at different stages in their corporate governance evolution. Some practices can be considered best practices, and some practices suggest further improvement is needed.

The risk of political interference is a challenge with government ownership. This interference in corporate governance could happen through government's influence through its relationship with utility management, or through its influence on the board of directors. Boards will therefore need to be alert to potential conflicts of interest (real or perceived). This issue may arise where directors are nominated by the government shareholder, including where there is more than one government shareholder (for example, multiple municipal shareholders). Although a director may have been nominated by one of the municipal shareholders, once appointed his/her duty is to the corporation as a whole. In other words, the director is required to consider the interests of all shareholders, not just the shareholder that appointed him/her.

If the director appointed by the municipal shareholder is a municipal employee or councillor, issues of potential conflict of interest may also arise. Under municipal law,

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[52] *OECD Guidelines*, p. 12.

councillors have specific duties to the council and the municipality. There are likely to be circumstances where these duties as councillor conflict with the duties of a corporate director of the utility.

Some of the same concerns arise for provincially-owned utilities. The boards of OPG and Hydro One do not include members of the legislature or government employees, so some of the concerns are mitigated. However, it remains a challenge for these boards to act solely in the best interests of the corporations without being unduly influenced by provincial policies which may not align with the corporation’s best interests. Ministerial Directives are a form of influence, but are transparent.

Another corporate governance concern arises in the context of HoldCo or parent company corporate structures. Investor-owned utilities in Ontario are generally the subsidiaries of larger Canadian or international corporations, and many of the municipally-owned utilities are held by HoldCos which have other non-regulated corporate holdings. In these situations, concerns about real or potential conflict of interest involving affiliated entities can arise. The Affiliate Relationships Code was established to address many aspects of these utility-affiliate transactions, and in particular requires that 1/3 of the utility board of directors be independent of all affiliates. However, if the corporate governance of a regulated utility is primarily provided at the parent company or HoldCo level, then there is less assurance that corporate governance decision-making at the regulated utility level is driven by an appropriate balance of shareholder and customer interests (as set out in *Toronto Hydro-Electric System v. Ontario Energy Board*). This concern arises because the HoldCo board will make decisions in the best interests of the overall corporation, and therefore the interests of the regulated utility will necessarily be balanced with the interests of other affiliates and the corporation overall. In situations where the HoldCo board has the substantive decision-making authority for the regulated utility (e.g. through a Shareholder Declaration) the concern around potential conflict is mitigated if the regulated utility is the only substantive business of the HoldCo.

The board of a utility must be informed of any potential conflict of interest and must determine how the responsibilities of the board will be discharged in a manner that is consistent with the fiduciary duties of the directors as described above. The board must also determine what practices will be adopted to ensure the directors fulfill their fiduciary duty and duty of care.

For all closely-held corporations, Unanimous Shareholder Agreements or Sole Shareholder Declarations may limit the power of the board of directors, by removing specific decision-making authorities from the board of directors and transferring them to the shareholder(s). Examples include decision-making related to capital expenditures, strategic planning, the issuance of debt, and acquisitions and disposals. Where the decision-making authority has been transferred, the liability is transferred as well. While these documents provide clarity and certainty as to the roles and responsibilities of the board of directors, if they transfer significant decision-making authority there is less scope for the board of directors of the regulated utility to exercise independent judgment within the framework of good corporate governance. Similar concerns may arise if these types of decisions are taken at the holding company (or parent company) level, rather than by the board of the regulated utility.[53] Elenchus is of the view that removing significant decision-making authority from the board of the regulated utility (and placing it with the holding company, parent company, or directly with the shareholders) effectively reduces the board's independence which may reduce the quality of the corporate governance from the regulator's perspective.

An additional consideration for municipally-owned distributors is the impact of municipal freedom of information legislation. The distributor is subject to the provisions of the *Municipal Freedom of Information and Protection of Privacy Act*, with some exceptions. This legislation also limits the ability of council to meet *in camera*, which would be an

[53] The OEB guidance will be directed at corporate governance at the level of the regulated utility, not the holding company.

important consideration if the municipality has used a Unanimous Shareholders Agreement (or Declaration) to transfer significant decision-making authority.

Elenchus has considered these factors in developing its recommendations for the OEB guidance, along with the monitoring and assessment tools. We have also considered the input of stakeholders. The next chapter sets out Elenchus' approach to developing a draft of the OEB guidance.

7 OEB GUIDANCE

The OEB commissioned Elenchus to develop draft guidance on corporate governance for Ontario's regulated natural gas and electricity utilities. Our preliminary version of this guidance was attached as Appendix 1 (*Preliminary Draft Guidance*) to our June 22, 2016 Draft Report. Elenchus discussed the *Preliminary Draft Guidance* with stakeholders in the stakeholder sessions. With the benefit of those discussions, Elenchus has prepared its recommended *Draft Guidance*, which is included at the end of this chapter. Elenchus benefited greatly from gaining a deeper understanding of the views, concerns, and proposals of stakeholders, and this has informed the process of developing *Draft Guidance* for the OEB. This section describes the overall approach that Elenchus has taken to develop the *Draft Guidance* and indicates how the stakeholder input has influenced our approach.

7.1 KPMG RECOMMENDATIONS

KPMG undertook a review of corporate governance by electricity distributors. Its research involving seven Ontario electricity distributors profiled the variety of structures and governance styles. KPMG also conducted interviews at seven distributors, which provided further insights into the current issues facing electricity distributors. In particular, KPMG noted that respondents had commented that municipal shareholder representation was better suited to the holding company than at the distributor level:

> *A prevailing view was that municipal shareholder representation on the Board should be minimized to ensure the Board is functionally aligned with the corporate strategy and always acts in the best interest of the corporation and the ratepayer. This can help minimize the potential for collision points on LDC vs. municipal strategic directions. It can also reduce personal conflicts of interests of*

municipal councillors and/or officials who may exhibit bias when advocating for constituency interests over the best interest of the corporation.[54]

Based on its research, KPMG reached a number of conclusions, including the following:

- Board composition varies widely: some boards are highly independent supported by professional skills and experience; others consist mainly of municipal representatives (either councillors or administrators).
- Board performance cannot be judged by board composition or independence alone. Performance is related to decision-making effectiveness, strategy, risk-taking behaviour, management practices and unforeseen events.
- It was generally recognized that adherence to the principles of accountability, transparency and independence are foundational to effective corporate governance.
- Governance practices vary depending on size, ownership structure, degree of municipal shareholder influence, complexity, strategy and risk profile.
- Board independence and decision-making can be challenging in circumstances where boards are comprised of independent directors and municipal councillors or administrators, depending on the degree of municipal shareholder influence and control exercised.
- It can be challenging to find local nominees who possess the requisite skills and experience, and this is compounded if there is limited access to ongoing training and education.

In its report to the OEB, KPMG recommended that the OEB establish guidelines for effective corporate governance for electricity distributors and that the guidelines should address the following areas:

- The role of the board of directors
- The composition of the board of directors

[54] KPMG Report for OEB, p. 38.

- The unique challenges of corporate governance in a municipal shareholder environment
- Board effectiveness criteria
- Committee structure and roles and responsibilities
- Strategic planning requirements
- Risk governance and enterprise risk management
- Management reporting to the board of directors
- The role of corporate governance in the OEB's regulatory process

Elenchus has considered these recommendations and incorporated many of the elements into the *Draft Guidance*.

7.2 OEB OBJECTIVES

The OEB has announced that it intends to provide guidance for effective corporate governance that reflects leading practices in the following areas: the role of a utility's board of directors; the unique challenges of corporate governance in a municipal shareholder and public utility environment; board effectiveness criteria; committee structure (including roles and responsibilities); strategic planning requirements; risk governance and enterprise risk management; and management reporting to the board of directors. These areas reflect the recommendations from KPMG. As set out in the letter announcing this initiative, the OEB expects its guidance to:

- Be based on principles rather than being prescriptive
- Leverage existing requirements which may be applicable to some or all utilities
- Recognize the specific circumstances of utility governance in Ontario

The *Draft Guidance* is based on Elenchus' expertise and experience and is designed to achieve these key OEB objectives, but it is not an OEB document.

7.3 ELENCHUS RECOMMENDATIONS

Elenchus believes that the OEB guidance should be grounded in established and recognized best practices and reflect the principles which are internationally recognized. The guidance should align with similar guidance already in place in other contexts, and in particular the guidance by securities regulators and OSFI.

It may well be appropriate for the OEB guidance to go further than other established guidance in areas of specific concern. However, this guidance should be grounded in the specific areas of corporate governance where OEB regulation is most engaged and the specific circumstances of Ontario's regulated utilities. This ensures that the guidance is aligned across sectors, and that the OEB is taking a proportionate and measured approach which recognizes its specific and unique concerns.

By implementing corporate governance guidance, Elenchus believes that the OEB is working proactively to protect the interests of consumers, promote efficiency and effectiveness and facilitate a financially viable sector.[55] In Elenchus' view, this approach makes the OEB a leader amongst utility regulators in this area by:

- Recognizing the importance of corporate governance to utility performance
- Integrating corporate governance considerations and regulatory considerations
- Leveraging good corporate governance to enhance regulatory effectiveness

Good corporate governance is more than just "ticking boxes" on a checklist. It embodies a culture of continuous improvement and assessment within a framework of appropriate independence, due diligence processes, and responsible disclosure. As OSFI has recognized, good corporate governance is the combination of structures and processes

[55] Without proactive action, regulators are left to examine the role of corporate governance only after the fact. For example, the CPUC is investigating the corporate governance of PG&E as part of the ongoing review of PG&E's actions leading up to and after the gas explosion in San Bruno, California.

with competent and committed people. Corporations, including the natural gas and electric utilities in Ontario, are at varying points along the continuum of good corporate governance. The development of OEB guidance can ensure a broad shared understanding of best practices and can provide a practical tool for utilities to demonstrate continuous improvement as they evolve along the continuum. The OEB's guidance must be theoretically sound, and it must also be pragmatic.

Although the OEB guidance should reflect best practice, it should not be overly detailed or prescriptive as to the precise practices to be used. This will allow utilities the flexibility to develop their corporate governance practices over time and in a way that best serves their needs. Generally, the guidance should emphasize the principles of good corporate governance, with greater detail and/or specific practices limited to those areas of greatest significance to the achievement of the OEB's regulatory objectives. There are many resources available to utilities, including publications such as *Directors' Responsibilities in Canada*, which provide detailed guidance on a wide range of governance issues and identify specific tools.[56]

Stakeholder Input

(Stakeholder input is presented in italics. Elenchus' responses are presented in regular text.)

Stakeholders endorsed the importance of good corporate governance generally, and as a determinant of utility performance in particular. Many stakeholders saw value in the OEB providing guidance in this area, in order to educate the sector and to clarify the OEB's perspective on the area. However, stakeholders want assurance that the guidance will not be mandatory, and they want more clarity around why the OEB is undertaking this initiative, including what problem the OEB is trying to address, the purpose of the guidance given other regulatory tools, what use will be made of the

[56] *Directors' Responsibilities in Canada*, Osler, Hoskin & Harcourt LLP and Institute of Corporate Directors, October 2014.

results of any assessment of governance, and what the benefits will be for customers and utilities. Stakeholders also want more specifics around the potential consequences of the monitoring and assessment. In general, stakeholders perceive potential negative consequences for utilities associated with the monitoring and assessment, and some suggested that it might be more effective to have a positive incentive to encourage the adoption of good corporate governance practices.

It is Elenchus' understanding that the OEB does not intend to regulate corporate governance on a systemic basis by prescribing specific practices. However, as the economic regulator, the OEB should be concerned with utility performance, and corporate governance is a major determinant of utility performance. The OEB also has a role in ensuring public confidence in utilities and the regulatory system generally. It follows that the OEB would be interested in the corporate governance of the utilities it regulates. By raising the profile of corporate governance (in the regulatory context) and by clearly articulating its perspective on the principles of corporate governance, the OEB can influence the sector for the purposes of improving performance. Elenchus concludes that the OEB will likely gain greater support for this initiative if it is able to provide clarity regarding its intentions, and in particular how the monitoring and assessment may impact individual utilities.

Some stakeholders noted that corporate governance is an input not an outcome and that the OEB should remain focused on outcomes, not inputs. Elenchus agrees that corporate governance practices are an input to overall utility performance. However, corporate governance practices are a strong indicator of likely utility performance. By monitoring and assessing corporate governance practices, the OEB will be better able to assess the quality of a utility's proposals and the ability of a utility to deliver on its plans and proposals without resorting to a line-by-line review.

Stakeholders think the guidance should be less prescriptive and more flexible in order to recognize that different corporate governance practices may be appropriate in different circumstances. Elenchus agrees that the wording and presentation of the *Preliminary*

Draft Guidance was similar to OEB codes and rules, and therefore created the impression that the guidance was mandatory. We have re-cast the *Draft Guidance* as a set of key principles, with examples of best practice provided. Most of the same material appears, but it is more clearly guidance based on principles, with the best practices presented as examples, rather than as prescriptive. In addition, the *Draft Guidance* explicitly acknowledges that there are alternative approaches, and that specific approaches will vary in particular circumstances.

A significant number of stakeholders were opposed to, or had concerns with, the proposals around independent directors and the definition of independence. The key points raised included the following:

- *There is value in having certain aspects of corporate governance provided by a larger entity such as a parent company or HoldCo. These benefits include access to greater expertise, more resources, and broader perspectives.*
- *Corporate governance needs to be focused on the entire business, not just the utility, because of the ongoing evolution of the sector and the appropriate role of an integrated business.*
- *Municipal councillors are, in effect, the elected representatives of customers, and therefore contribute significantly to the governance of the utility.*
- *Having additional independent directors would add unnecessary cost and complexity to the overall corporate governance.*
- *The OEB's definition of independence should not extend beyond the definitions used by securities regulators or in the Affiliate Relationships Code.*
- *Requiring directors to be "independent of shareholders" would be excessively restrictive. For example, a director who owned any shares directly would not be considered independent.*

Elenchus had proposed that a utility board should have a majority of directors who are independent of management, independent of affiliates, and independent of shareholders. Stakeholders had a variety of views about what constitutes an "independent" director or how "independence" should be interpreted. The input demonstrated the breadth of views as to what constitutes genuine independence and identified potential shortcomings with the Elenchus proposals. Elenchus has considered these issues, as well as the points identified above, and concluded that the OEB guidance should address the issue in light of the specific circumstances of utility ownership in Ontario.

Elenchus concludes that best practice from a regulatory perspective would be to have a majority of directors at the regulated utility level who are independent of management, independent of affiliates, and are not the employees or councillors of municipal shareholders. This would recognize that the governance of the regulated utility should be focused on balancing the interests of shareholders and ratepayers/customers, without undue influence from affiliates, parent companies, or municipal shareholders with a substantial ownership position (but which are not technically affiliates). This approach would still provide flexibility for utilities to have a significant proportion of directors who are members of management, or employees or directors of an affiliate, or municipal employees or councillors.

This approach reflects best practice generally. *National Policy 58-201 (Corporate Governance Guidelines)* states that the board should have a majority of independent directors. The Canadian Coalition on Good Governance, which represents the interest of shareholders, states that "a board always should have a meaningful number of independent directors who are not related to the controlling shareholder or management."[57] Ontario's Distribution Sector Review Panel recommended that regional electricity distributors (which were the recommended vehicle for consolidation) should have a minimum of 2/3 independent directors, and preferably 100% independent.[58]

[57] Canadian Coalition on Good Governance, *Governance Differences of Equity Controlled Corporations*, October 2011, p. 1.

[58] *Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First*, The Report of the Ontario Distribution Sector Review Panel, December 2012, p. 38.

The *OEB Act* has recently been amended to remove the restrictions on the business activities of the affiliates of electricity distributors and to allow electricity distributors to undertake non-distribution activities under special circumstances, if approved by the OEB.[59] The *OEB Act* also now includes the fiduciary duty and duty of care for utility directors. These factors demonstrate the importance of independence within a strong corporate governance structure.

Under the *Affiliate Relationships Code* (ARC) and securities regulator definitions of independence, a utility director who is an employee or councillor of a municipal shareholder that controls the utility (typically through the ownership of a majority of its shares) would not be considered independent, just as a utility director who is an employee or director of a parent corporation would not be considered independent. However, a councillor (or employee) of a municipality owning less than 50% of the utility would be considered an independent director, because in those circumstances the municipality would not be an affiliate under the *OBCA*. The same situation arises for Hydro One as the provincial ownership position is reduced, but Hydro One's board currently includes no provincial employees or elected officials.

Elenchus does not propose to alter the definition of independence. This would create confusion and inconsistency with other definitions of independence, and was strongly resisted by stakeholders. However, Elenchus does conclude that additional considerations are warranted in light of the ownership structure of Ontario's utilities and the OEB's regulatory focus for the guidance.

In Ontario, the two large natural gas utilities are wholly owned by parent corporations, and therefore any directors on the board of the utility who are employees or directors of the parent company would not be considered independent. Almost all of the electric utilities are owned by either the province or by one or more municipalities. The result is that employees or elected officials of a majority shareholder (either a municipality or the

[59] The provisions were included in Bill 112, which received Royal Assent December 3, 2015.

provincial government) would not be considered independent, but the employees or elected officials of a minority shareholder (either a municipality or the provincial government) would be considered independent.

Municipal councillors are elected representatives, but a councillor's role as a director is neither to represent the interests of customers nor to make decisions on their behalf. While direct municipal representation (either by a councillor or a municipal employee) can bring value to a board, Elenchus concludes that best practice from a regulatory perspective would be to have a majority of directors who are not employees nor councillors of municipal shareholders (as well as being independent of utility management and affiliates). For example, if the board of directors for a utility owned by three municipalities (with none having more than 50%) were composed entirely of councillors and/or municipal employees, all the directors would be "independent of affiliates" as these terms are defined. However, Elenchus concludes that this situation could raise concerns from a regulatory perspective on governance, given the challenges arising from the dual and potentially conflicting loyalties of the councillors or employees, as well as concerns related to potential conflict of interest or undue influence. While these directors can bring value to the utility board, the OEB has an interest in ensuring that decisions by a utility's board of directors are focused clearly on the best interests of the utility (including balancing the interests of shareholders and customers) and in limiting areas of potential conflict of interest.

The same concerns (potential conflict of interest, dual loyalties, undue influence) could arise if/when the provincial government has a minority ownership position in Hydro One, because in that situation a provincial employee or elected official appointed to the board would be considered independent. However, the rest of the Hydro One's shareholders are broad-based, with none allowed to hold more than 10%. Government employees or elected officials are therefore very unlikely to be a significant component of the board, particularly given that none serve as directors currently.

Some stakeholders expressed the view that the ARC is the appropriate tool for the OEB to oversee the utility-affiliate relationship. The ARC is an important regulatory tool, but it is focused on the transactional aspects of the utility-affiliate relationship, whereas corporate governance structures and practices are systemic in nature. In addition, the ARC is mandatory, while the guidance is an expression of the OEB's perspective on best practices for utility corporate governance, and is entirely voluntary. Some stakeholders maintained that the utility board need not be majority independent if the parent is a reporting issuer, or if the parent is investor-owned, or if the parent board is fully independent. However, the board of the regulated utility has a different mandate than the board of the parent, namely a focus on the best interests of the utility (including balancing the interests of shareholders and ratepayers/customers).

Utility boards which meet this regulatory best practice for governance could still have a significant number of directors overlap with the parent or HoldCo, thereby benefiting from the corporate governance expertise at the higher corporate level, for example in areas such as risk management and strategy. Utilities could also continue to have councillors or municipal employees as directors. While having additional directors at the utility level, who are independent and not elected officials or employees of provincial or municipal shareholders, may add additional cost, this cost would generally be modest in relation to overall corporate governance costs.

Elenchus also recognizes that there should be flexibility to recognize that different approaches, based on particular circumstances, can also constitute good corporate governance. For example, if a utility HoldCo has no substantive non-regulated business, then having a majority of directors at the HoldCo level who are independent of management and affiliates and who are not municipal councillors or employees may accomplish the same objective as having those directors at the utility level.

If the majority of utility board directors does not meet the regulatory best practice for governance set out above, or if key decision-making authority is at the HoldCo or parent level, then the key decisions affecting the utility and its customers (strategy, capital plans, dividends, etc.) should still be taken in the best interests of the regulated utility (including balancing the interests of shareholders and customers) independent of considerations related to other businesses of the corporation or undue interference. This could be demonstrated by having a majority of the independent directors who are not municipal councillors or employees approve certain decisions, or by having a committee of such directors review such issues. This represents additional flexibility in the guidelines.

This alternative approach to approving certain key matters would adopt the principle of one of the OEB's key decisions (that a majority of the independent directors approve any dividend) and is consistent with related case law.[60] This approach is also consistent with best practice as described by the G20/OECD. In its discussion of related-party transactions, the G20/OECD emphasizes that conflicts of interest should be disclosed, that there is value in independent directors having a prominent role in the decision-making of the board, and that it is good practice for the director in a conflict position to have no role in the decision-making.[61]

The approaches described above would address issues of potential conflict of interest and potential undue influence and provide a level of assurance in which the OEB and stakeholders can have confidence.

If the approaches described above are not possible (e.g. because no directors are both independent and not municipal councillors or employees), then the utility should explain in its baseline reporting how its corporate governance practices address the regulatory concerns related to potential undue influence, potential conflict of interest, and dual loyalties.

[60] EB-2005-0421, Toronto Hydro-Electric System Limited, Decision with Reasons, April 12, 2006, and the associated Court of Appeal decision.

[61] G20/OECD, pp. 25-26, 52.

Final Recommendations

Elenchus has developed the following recommendations with respect to the foundation, scope and content for the OEB guidance:

- **Recommendation 1.1: The OEB guidance should be consistent with the principles in G20/OECD guidance, aligned with financial and securities regulator guidance, and consistent with the major sources for best practices in Canada, including ICD/Osler's *Directors' Responsibilities in Canada* and CCGG's *Building High Performance Boards*. The OEB should tailor its guidance to focus on the areas of greatest importance to regulated utilities and rate regulation.**

  ***Rationale**: This will align the OEB guidance with internationally recognized standards for good corporate governance and financial and securities sector guidance and reflect current best practices in Canada. This recognizes the common goals amongst regulators to foster good corporate governance and provides consistent guidance to utilities that are subject to securities regulator guidance. However, the OEB's mandate differs from that of securities and financial regulators in that the OEB has a broad public interest mandate and a specific objective to protect the interests of consumers. Therefore, the OEB's corporate governance guidance should align with the OEB's mandate and objectives. The OEB should develop its own guidance in order to recognize and address the particular characteristics of Ontario's regulated utilities and to address the specific areas of greatest focus for the OEB.*

- **Recommendation 1.2: The OEB guidance should be structured in accordance with the following principles:**

  - **Principle #1: The responsibilities of the board and of directors should be defined and transparent**: The board of directors is responsible for setting the utility's strategy, overseeing the risk of the utility, monitoring the financial and operational performance of the utility, and selecting and evaluating the CEO.

- **Principle #2: Directors should exercise their independent judgment in the best interests of the utility with appropriate balance given to the interests of customers**: Directors must be skilled in a variety of areas (including technical skills such as legal, engineering, accounting, and regulatory, and governance skills such as integrity, collegiality, and strategic thinking) and committed to the long-term best interests of the utility, including balancing the interests of customers and shareholders. They must be able to challenge management while working cooperatively in the long-term best interests of the utility.

- **Principle #3: The structure of the board should support the effective and efficient operation of the board as it fulfills its responsibilities, particularly the exercise of independent business judgment in the best interests of the utility**: The roles and responsibilities of the board, the committees and the individual directors must be clear and robust. The structure of the board may vary, depending upon factors such as the complexity of the business and the overall corporate structure.

- **Principle #4: The board should adopt policies and practices which facilitate high performance and which ensure that the conduct of the board meets the highest standards of skill, integrity, and diligence**: The directors (and the board as a whole) must conduct themselves with the highest integrity, using the appropriate tools to govern conflict of interest, risk, strategy, stakeholder interests, communications, and assessment. They must have the policies and practices in place to support high performance and continuous improvement.

***Rationale**: This approach provides an overall structure which recognizes four key principles of corporate guidance from a regulatory perspective. The quality of utility corporate governance is an important factor in maintaining the confidence of customers and regulators, shareholders and debt holders, as well being an important indicator of financial integrity. The OEB guidance should therefore draw attention to specific areas of corporate governance that are especially important for utilities, owing to the unique nature and circumstances of utilities, their ownership structures, and the risks assumed relative to other corporations. However, the guidance should be consistent with established best practices, as reflected in a variety of expert external sources, and be flexible to recognize that specific approaches may vary depending upon the particular circumstances.*

The Draft Guidance includes provisions related to director independence, conflict of interest, risk, strategy, stakeholder interests, communication, and assessment.

The OEB guidance is the first part of a three-part approach to corporate governance contemplated by the OEB. The OEB announced that it also intends to develop monitoring and assessment tools to complement its corporate governance guidance. We address monitoring in the next chapter, and assessment in Chapter 9. Below we set out the Elenchus recommended Draft Guidance.

7.4 ELENCHUS RECOMMENDED DRAFT GUIDANCE

THIS *DRAFT GUIDANCE* HAS BEEN PREPARED BY ELENCHUS.
IT IS NOT AN OEB DOCUMENT.

Purpose of the Guidance

Good corporate governance among Ontario's regulated utilities will benefit utilities and their stakeholders (including customers) and will assist the Ontario Energy Board (OEB) to discharge its regulatory mandate. This Guidance sets out the OEB's perspective regarding the principles of good corporate governance, and the associated structures, policies and practices. The purpose of this Guidance is to:

- Promote best practices in utility corporate governance, particularly in the areas of key focus for the OEB
- Incent continuous improvement in utility corporate governance

This Guidance is consistent with national and international principles and best practices, and it is also consistent with Canadian securities regulation guidance. The OEB Guidance is less detailed than securities regulation guidance, and is focused on the issues of greatest relevance for the OEB's regulation of utilities.

This Guidance reflects good corporate governance principles and is applicable to all rate regulated natural gas and electricity utilities in Ontario and Ontario Power Generation. This Guidance does not set mandatory requirements or minimum standards. However, utilities are expected to consider this Guidance in developing their own corporate governance practices. Utilities will be required to disclose their governance practices, along with their analysis of how their practices align with the principles and practices contained in this Guidance.

The Guidance is organized according to the following key principles of good corporate governance:

- **Principle #1: The responsibilities of the board and of Directors should be defined and transparent.**

- **Principle #2: Directors should exercise their independent judgment in the best interests of the utility with appropriate balance given to the interests of customers.**

- **Principle #3: The structure of the board should support the effective and efficient operation of the board as it fulfills its responsibilities, particularly the exercise of independent business judgment in the best interests of the utility.**

- **Principle #4: The board should adopt policies and practices which facilitate high performance and which ensure that the conduct of the Board meets the highest standards of skill, integrity and diligence.**

Principle #1: The Responsibilities of the Board and of Directors should be defined and transparent.

Best Practices include:

- The board of directors adopts a written mandate in which it acknowledges responsibility for the stewardship of the utility and sets out its responsibilities, including:
  - Adopting a strategic planning process and approving a strategic plan
  - Identifying the principal risks of the utility's business, and ensuring the implementation of appropriate systems to manage these risks
  - Succession planning (including selecting and evaluating the CEO)

    - Monitoring financial and operational performance of the utility and ensuring appropriate internal controls and information systems
    - Developing the utility's approach to corporate governance, including an assessment process
    - Adopting measures for receiving feedback from stakeholders
    - Setting the expectations and responsibilities of directors, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials, and director assessment process.
    - The board develops clear position descriptions for the chair of the board and the chair of each board committee.
- The board, together with the CEO, develops a clear position description for the CEO, which includes delineating management's responsibilities.

Rationale*: As stewards of the utility, the board of directors of the utility is responsible for setting the utility's strategy, overseeing the risk of the corporation, monitoring the performance of the corporation, and selecting and evaluating the CEO. Written mandates ensure clarity and shared understanding of the roles and responsibilities of the board and directors, demonstrate commitment to the mandate, and bring transparency to the utility's corporate governance, although the level of detail may vary depending upon the particular circumstances. (Each of these provisions appears in National Policy 58-201, although they have been modified to remove some of the detail.)*

Principle #2: Directors should exercise their independent judgment in the best interests of the utility with appropriate balance given to the interests of customers.

Best Practices include:

- The board has a majority of directors who are independent of management and independent of affiliates, and are not the employees or councillors of municipal shareholders.

  Rationale**: This approach recognizes that the governance of the regulated utility should be focused on balancing the interests of shareholders and customers, without undue influence from affiliates, parent companies, or shareholders with a substantial ownership position (but which are not technically affiliates).* ***This approach would still provide flexibility for utilities to have a significant proportion of directors who are members of management, or employees or directors of an affiliate, or municipal employees or councillors.

  This approach reflects best practice generally. National Policy 58-201 (Corporate Governance Guidelines) states that the board should have a majority of independent directors. The Canadian Coalition on Good Governance, which represents the interest of shareholders, states that "a board always should have a meaningful number of independent directors who are not related to the controlling shareholder or management."[62] Ontario's Distribution Sector Review Panel recommended that regional electricity distributors (which were the recommended vehicle for consolidation) should have a minimum of 2/3 independent directors, and preferably 100% independent.[63]

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[62] Canadian Coalition on Good Governance, *Governance Differences of Equity Controlled Corporations*, October 2011, p. 1.

[63] *Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First*, The Report of the Ontario Distribution Sector Review Panel, December 2012, p. 38.

Under the Affiliate Relationships Code (ARC) and securities regulator definitions of independent, a utility director who is an employee or councillor of a municipal shareholder that controls the utility (typically through the ownership of a majority of its shares) would not be considered independent, just as a utility director who is an employee or director of a parent corporation would not be considered independent. However, a councillor (or employee) of a municipality owning less than 50% of the utility would be considered an independent director, because in those circumstances the municipality would not be an affiliate under the Business Corporations Act (Ontario). The same situation arises for Hydro One as the provincial ownership position is reduced, but Hydro One's board currently includes no provincial employees or elected officials.

Municipal councillors are elected representatives, but a councillor's role as a director is neither to represent the interests of customers nor to make decisions on their behalf. While direct municipal representation (either by a councillor or a municipal employee) can bring value to a board, best practice from a regulatory perspective would be to have a majority of directors who are not employees or councillors of municipal shareholders (as well as being independent of utility management and affiliates). For example, if the board of directors for a utility owned by three municipalities (with none having more than 50%) were composed entirely of councillors and/or municipal employees, all the directors would be "independent" as independence is defined. However, this situation could raise concerns from a regulatory perspective on governance, given the challenges arising from the dual and potentially conflicting loyalties of the councillors or employees, as well as concerns related to potential conflict of interest or undue influence. While these directors can bring value to the utility board, the OEB has an interest in ensuring that decisions by a utility's board of directors are focused clearly on the best interests of the utility (including balancing the interests of shareholders and customers) and in limiting areas of potential conflict of interest.

The same concerns (potential conflict of interest, dual loyalties, undue influence) could arise if/when the provincial government has a minority ownership position in Hydro One, because in that situation a provincial employee or elected official appointed to the board would be considered independent. However, the rest of the Hydro One's shareholders are broad-based, with none allowed to hold more than 10%. Government employees or elected officials are therefore very unlikely to be a significant component of the board, particularly given that none serve as directors currently.

There should be flexibility to recognize that different approaches, based on particular circumstances, can also constitute good corporate governance. For example, if a utility HoldCo has no substantive non-regulated business, then having a majority of directors at the HoldCo level who are independent of management and affiliates and who are not municipal councillors or employees may accomplish the same objectives as having those directors at the utility level.

- If the board does not have a majority of directors who are independent of management and independent of affiliates, and are not the employees or councillors of municipal shareholders, then a majority of independent directors (who are not municipal employees or councillors) approves board decisions in areas involving significant potential conflict of interest, for example dividends and related-party debt. Alternatively, a committee of such directors reviews such issues for purposes of making recommendations to the Board as whole.

  ***Rationale**: The guidance should incorporate flexibility for utilities to take different approaches to meeting the key principles. If the board does not have a majority of directors who are independent of management and independent of affiliates, and who are not employees or councillors of municipal shareholders, or if key decision-making authority is at the HoldCo or parent level, then the key* *decisions affecting the utility and its customers (strategy, capital plans, dividends, etc.) should still be taken in the best interests of the regulated utility (including balancing the interests of shareholders and customers) independent of considerations related to other businesses of the corporation or undue interference. This could be demonstrated by having a majority of the independent directors (who are not municipal employees or councillors) approve certain decisions, or by having a committee of such directors review the issue.*

This alternative approach to approving certain key matters would adopt the principle of one of the OEB's decisions (that a majority of the independent directors approve any dividend), and is consistent with related case law.[64] *This approach is also consistent with best practice as described by the G20/OECD. In its discussion of related-party transactions, the G20/OECD emphasizes that conflicts of interest should be disclosed, that there is value in independent directors having a prominent role in the decision-making of the board, and that it is good practice for the director in a conflict position to have no role in the decision-making.*

If the approaches described above are not possible (e.g. because no directors are both independent and not municipal councillors or employees), then the utility should explain in its baseline reporting how its corporate governance practices address the regulatory concerns related to potential undue influence, potential conflict of interest, and dual loyalties.

- The chair of the board is an independent director (and not an employee or councillor of a municipal shareholder).
- There are term limits for board directors to facilitate board renewal.

[64] EB-2005-0421, Toronto Hydro-Electric System Limited, *Decision with Reasons*, April 12, 2006, and the associated Court of Appeal decision

- The independent directors (who are not employees or councillors of municipal shareholders) hold regularly scheduled meetings at which other directors and members of management are not in attendance (*in camera*).
- The Board develops a skills matrix for directors. Directors are nominated on the basis of their skills and competencies, their integrity, and their commitment to the work of the board. The board adopts a policy and/or targets relating to the identification and consideration of women as directors.
- The board ensures that all new directors receive a comprehensive orientation.
- The board provides continuing education opportunities for all directors, to enhance their skills as directors and to ensure their understanding of the utility's business remains current.

Rationale*: Directors must be committed to acting honestly and in good faith with a view to the best interests of the utility and committed to exercising the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. In order to do this successfully, directors must be skilled and capable of fulfilling their duties. To be effective, directors must challenge management and consider the interests of all stakeholders, while working cooperatively in the best long-term interests of the utility. Boards must provide directors with access to appropriate orientation, education and development opportunities in order to promote excellence in corporate governance. (Similar provisions appear in National Policy 58-201, but have been modified to simplify the provisions.)*

Principle #3: The structure of the Board should support the effective and efficient operation of the Board as it fulfills its responsibilities, particularly the exercise of independent business judgment in the best interests of the utility.

Best Practices include:

- The board appoints the necessary committees to fulfill its responsibilities and conduct its work effectively. Generally there is an Audit Committee. Other committees could include Human Resources, Nominating, Governance, and Risk.

- Each committee has a written charter that establishes the committee's purpose, responsibilities, structure and operations.

***Rationale**: The board has a broad range of responsibilities. In order to work effectively and efficiently the board should consider using committees to assist it in fulfilling its responsibilities. The roles and responsibilities of board committees should be clear and robust to ensure shared understanding of roles and responsibilities. The specific structure for a board will depend upon a number of factors, including the complexity of the business and the overall corporate structure. However, all utilities would benefit from having an Audit Committee, given the importance of financial performance to the delivery of safe and reliable energy services and the need to consider financial issues of the utility in some detail and with the benefit of suitable expertise. (Securities regulation requires that there be an Audit Committee for reporting issuers.) Several other committees should be considered as well.*

The key tasks for of the most common committees are set out below. However, each committee could well have other responsibilities – the list is not intended to be exhaustive. Boards may also consider combining committees for efficiency purposes, for example a combined Human Resources and Governance Committee. Although some corporations have Risk Committees, many do not. If there is no Risk Committee, the key Risk Committee tasks set out below would be integrated into the responsibilities of other committees, and overall oversight would be provided by the board as a whole. Even though the board may delegate responsibilities to committees, the board as a whole retains the ultimate authority and responsibility for all matters.

The provisions below have been adapted from similar provisions in National Policy 58-201 and National Instrument 52-110. However, they have been simplified and streamlined.

Audit Committee

- A majority of directors on the Audit Committee are independent (and not employees or councillors of municipal shareholders) and all are financially literate.
- The Audit Committee is responsible for overseeing the financial reporting process, including:
    - Overseeing the work of the external auditor
    - Pre-approving all non-audit services to be provided by the external auditor
    - Reviewing the utility's financial statements and MD&A
    - Overseeing the work of internal audit
    - Overseeing the system of internal controls

Human Resources and Compensation

- A majority of the Directors on the Human Resources Committee are independent (and not employees or councillors of municipal shareholders).
- The Human Resources Committee is responsible for:
    - Reviewing and approving corporate goals, objectives and policies relevant to CEO selection and compensation
    - Selecting the CEO, evaluating the CEO's performance, and determining the CEO's compensation level based on the evaluation (or making recommendations to the board)
    - Making recommendations to the board with respect to non-CEO officer and director compensation
    - Succession planning for CEO and senior executives
    - Human resource oversight, including labour relations, ethical conduct and compensation policies

Nominating Committee

- A majority of directors on the Nominating Committee are independent (and not employees or councillors of municipal shareholders).
- The Nominating Committee is responsible for identifying and recommending new director nominees by considering:
    - The necessary competencies and skills for the board (skills matrix)
    - The competencies and skills of the existing directors
    - The competencies and skills of each nominee
    - Any policy and/or target relating to diversity on the board, including women

Governance Committee

- A majority of directors on the Governance Committee are independent (and not employees or councillors of municipal shareholders).
- The Governance Committee is responsible for
    - Recommending board policies and processes for effective and efficient governance
    - Recommending policies for the evaluation of individual directors and the board overall
    - Reviewing the corporate bylaws
    - Overseeing plans for board education, including new director orientation, director education and development, and board development

Risk Committee

- A majority of directors on the Risk Committee are independent (and not employees or councillors of municipal shareholders).
- The Risk Committee is responsible for:
    - Developing processes and practices to identify, measure and mitigate risk, including in the areas of enterprise risk, financial management, and cybersecurity

- Developing recommendations for the corporation's risk tolerance policy
- Overseeing the processes and controls in place to manage risk

Principle #4: The Board should adopt policies and practices which facilitate high performance and which ensure that the conduct of the Board meets the highest standards of skill, integrity and diligence.

Best Practices include:

Code of Conduct

- The board adopts a written code of business conduct and ethics (applicable to directors, officers and employees). The code includes standards that are designed to promote integrity and to deter wrongdoing and address the following issues:
    - Conflicts of interest
    - Protection and proper use of corporate assets and opportunities
    - Confidentiality of corporate information
    - Fair dealing with the utility's security holders, customers, suppliers, competitors and employees
    - Compliance with laws, rules and regulations
    - Reporting of any illegal or unethical behaviour
- The board is responsible for monitoring compliance with the code. Any waivers from the code that are granted for a director or executive officer are granted by the board (or a board committee) only.

Rationale*: The individual directors and the board as a whole must conduct itself with the highest integrity, using the appropriate tools to govern communications, conflicts and relationships and to set, evaluate and improve individual and overall performance. These are particularly important given that utilities are providing an vital public utility service and given the ownership structure of utilities in Ontario.*

(This provision has been adapted from provisions in National Policy 58-201, although it has been simplified and streamlined.)

Conflict of interest, risk, strategy, stakeholder engagement, and communication are areas directly relevant to OEB regulation and therefore warrant specific guidance, which are set out below.

Conflict of Interest

- The board develops processes and practices which promote independent decision-making by the board and which address issues of potential conflict of interest involving decisions on matters such as dividends, affiliate transactions, major investments, and non-utility business activities.

***Rationale**: There may be concerns as to whether the board is sufficiently independent when there are directors who are municipal councillors or parent company employees, or when there are interlocking appointments. These types of directors raise particular concerns about divided loyalties and conflicts of interest. By specifically addressing this issue in its governance practices, there can be greater confidence that board decision-making is being done in the best interests of the utility, taking into account the interests of all stakeholders.*

Risk

- The board develops processes and practices to effectively identify, measure, and mitigate risk. The board explicitly identifies the utility's risk tolerance and oversees the processes and controls in place to manage risk.

Strategy

- The board develops processes to ensure the development of a strong strategic plan. The board approves the utility's strategy, and the board oversees the implementation of the plan, the alignment with regulatory proposals, and the assessment of utility performance against the plan.

Stakeholder Interests

- The board develops processes and practices that promote effective consideration of stakeholder interests as part of the board's decision-making. This includes the consideration of the impacts of rate proposals on customers.

Communication

- The board develops processes and practices that promote effective and appropriate communication, including:
  - Information sharing between the board and management
  - Information sharing between the board and the shareholders
  - Disclosure of corporate governance practices

***Rationale**: The guidance on risk, strategy, stakeholder interests, and communication are related to areas of specific relevance to OEB regulation. These are areas where it is particularly important for the utility board to exercise its independent business judgment in balancing the interests of shareholders and customers and in governing in the best interests of the utility. The guidance has been adapted from the provisions in National Policy 58-20, and reflects best practice, as set out (for example) in the CCCG's Building High Performance Boards and 2015 Best Practices and the G20/OECD's Principles of Corporate Governance. These best practices do not stipulate how the issues should be addressed, just that they should be addressed through the clear processes and practices. This provides broad flexibility for utilities to develop policies and practices which are suitable for their circumstances.*

Assessment

- The board and its committees conduct regular assessments of their effectiveness.
- Each director is regularly assessed regarding his/her effectiveness.

***Rationale**: Assessment is a key step in continuous improvement, and widely recognized as best practice. The guidance is similar to the provisions of National Policy 58-201, but it has been streamlined.*

8 MONITORING

Once the OEB has established its guidance for corporate governance, it will be important to monitor utility practices. Monitoring will provide greater transparency around utility corporate governance and assist the OEB with assessing whether utility corporate governance practices are aligned with the OEB's expectations and furthering the OEB's objectives for corporate governance within the broader regulatory framework.

This chapter sets out the Elenchus recommendations for monitoring corporate governance. As in the prior section on the OEB guidance, we start with a description of KPMG's recommendations and the OEB's objectives. We then present a summary of the stakeholder input received in response to our draft recommendations. We reflect on that input and present our final recommendations.

8.1 KPMG RECOMMENDATIONS

KPMG included the following recommendation in its 2015 report to the OEB:

> *The OEB should monitor leading behavioural indicators which may also be reflective of the effectiveness of overall corporate governance and decision-making effectiveness of an LDC. These indicators may include:*
>
> - *significant changes in business strategy;*
> - *acquisitions or major investments;*
> - *increased risk-taking behaviour;*
> - *increased operational, health, safety or environmental incidents or;*
> - *major changes to the Board composition.*[65]

[65] KPMG, *Review of Corporate Governance of Electricity Distributors*, Final Report, April 29, 2015, p. 45-46.

Elenchus believes that these can be useful indicators within a broader, more holistic approach to monitoring, based on disclosure, in line with the OEB's overall corporate governance objectives and specific objectives for monitoring.

8.2 OEB OBJECTIVES

Elenchus' understanding is that the OEB intends to identify indicators to assist with the on-going monitoring of the effectiveness of a utility's corporate governance, for example using the indicators identified by KPMG. Further, Elenchus understands that the OEB seeks a process which is more substantive and robust than a "checklist" approach, but not one which is overly intrusive.

8.3 ELENCHUS RECOMMENDATIONS

One of the OEB's overall objectives is to encourage good corporate governance through the regulatory process. However, the demonstration of good corporate governance must be more substantive than a checklist of corporate governance practices. Utilities should demonstrate and substantiate their good corporate governance. Disclosure is an important component of an overall approach to monitoring and assessment. Along with the content of the disclosure, the quality and timeliness of the disclosure can provide a strong indication of the quality of the governance practices. Previously, the OEB required disclosure of corporate governance information through its filing requirements, however those filing requirements are not currently in place (see Appendix 3).

Stakeholder Input

(Stakeholder input is presented in italics. Elenchus' responses are presented in regular text.)

Stakeholders were concerned about the reporting in terms of cost, duplication, and confidentiality. Many pointed out that their parent company was already subject to extensive corporate governance reporting requirements as a result of securities regulator disclosure requirements. Others noted that they already do a significant amount of reporting to the OEB, and if new requirements are added, then perhaps other requirements should be removed. Some stakeholders also pointed out that the OEB requires corporate governance reporting in cost of service applications (although those filing requirements have recently been removed). Many expressed concern that the proposed reporting might require utilities to disclose confidential information, for example the content of board deliberations or the results of board assessments.

Elenchus understands that reporting requirements involve additional cost and regulatory burden. However, transparency around corporate governance practices is itself a hallmark of good corporate governance, and Elenchus concludes that some form of baseline disclosure is warranted. And although preparing a baseline corporate governance report is a substantial undertaking, maintaining its accuracy is much less resource intensive as it involves updating to reflect changes only. This baseline reporting could be done through the cost of service filing, or an alternative means.[66]

Some stakeholders suggested that reporting was only necessary if the OEB perceived a problem or a gap. However, without the information it is not clear how the OEB would identify a gap. And if one of the OEB's goals is to encourage improved corporate governance knowledge and practices generally, then baseline reporting by all regulated utilities would be an effective tool.

Some stakeholders emphasized that they did not want to duplicate existing reporting. Elenchus agrees that if corporate governance information is already reported at the regulated utility level, then that reporting should be sufficient for the OEB's purposes in

[66] London Hydro's *Statement of Corporate Governance Practices* is an excellent example of a substantive baseline report of corporate governance.

the area of baseline reporting. However, if the reporting is at the parent company level only, then that does not provide the OEB with information about corporate governance at the regulated utility level. The OEB is concerned with practices at the regulated utility level (or the HoldCo level if the utility is the only substantive holding), and so the reporting would be needed at that level.

In addition to baseline reporting, the OEB should consider more in depth reporting, on a periodic basis, on specific key issues. In our draft recommendations for monitoring we identified a number of key areas where the OEB might benefit from more detailed regular reporting. After reflecting on the stakeholder input we have concluded that detailed reporting on these key areas is not necessary on a regular basis. Elenchus recommends that more detailed monitoring (and reporting) should be done as part of a periodic assessment of a key issue. We have therefore moved discussion of that issue to the next chapter on assessment.

Final Recommendations

Elenchus makes the following recommendations to the OEB around the content and frequency for reporting of corporate governance practices:

- **Recommendation 2.1: The OEB should implement disclosure requirements for baseline utility corporate governance information.**

  Rationale*: The importance of disclosure has been recognized by financial and securities regulators, as well as by external organizations like the Canadian Coalition for Good Governance (which represents large institutional shareholders). Disclosure enhances transparency around governance practices, itself a characteristic of good corporate governance, and aids assessment by external parties. Under the Canadian "principles-based" approach to securities regulation (with the exception of mandatory rules relating to audit committees), a company is required to publicly disclose the extent to which it meets the identified* *best practices and, where its practices differ from the guidelines, to describe how its practices meet the same corporate governance objectives.*

Under this approach, each utility would disclose its corporate governance practices and whether they align with the OEB guidance. To the extent a utility's corporate governance practices differed from the guidance, then the utility would explain whether and how its approach achieves the principles set out in the OEB guidance.

Elenchus proposed a formal self-assessment or self-certification process in its draft recommendations, but we have removed that from our final recommendations. Elenchus concludes that effective baseline disclosure (including analysis of the alignment with the OEB's guidance) along with periodic updates for changes, will accomplish the same objective at this time. This approach is more light-handed and is consistent with the voluntary nature of the guidance. The OEB may wish to revisit the idea of formal self-assessment/self-certification at a later time.

- **Recommendation 2.2: The baseline reporting should include disclosure of corporate governance practices in each of the areas identified in the guidance, and should include reporting in specific areas of interest from a regulatory perspective.**

***Rationale**: As has been recognized by OSFI, it is relatively easy to monitor (and assess) the structural elements of corporate governance, but it is harder to monitor (and assess) the behavioural elements of corporate governance. CCGG makes a similar observation in commenting that it cannot observe directly what goes on in the corporate boardroom. The challenge for regulators is to identify the information that can assist in identifying areas of concern or risk which may exist within the utility.*

KPMG recommended that the OEB assess and understand the potential drivers facing utilities which might lead to increased risk-taking or other adverse behaviour. KPMG recommended that the OEB monitor significant changes to board composition, risk profile, business strategy, acquisitions/investment, or health/safety/environmental incidents. Elenchus has included these areas, but believes that the OEB should also consider other information, as these indicators alone may not be sufficient. For example, KPMG recommended that the OEB be advised of any substantial changes in strategy. However, given the pace of technological change in the sector, significant risks may arise if a utility does ***not*** *change its business strategy in response to changing technology.*

Elenchus therefore recommends specific baseline disclosure in some areas which are of particular relevance to the OEB, given its statutory mandate and the state of utility sector. The following disclosures are recommended as part of the baseline reporting:

- **Board responsibilities**: Disclose all Unanimous Shareholder Agreements or Sole Shareholder Declarations. This will show the extent of the decision-making authority of the utility board of directors. Disclose the mandates and/or charters for the board and each of the committees.

- **Director independence**: Disclose the name of each director and whether he/she is independent and the criteria used to determine independence and whether he/she is a councillor or employee of a municipal shareholder. If the majority of the board is not independent, provide an explanation of how the board maintains independent judgment.

- **Director selection**: Disclose the necessary qualifications (e.g. the skills matrix) and selection process, including considerations of gender and diversity. Disclose orientation, education and development practices. Disclose the attendance record of directors (including committees).

- **Board assessment**: Disclose the methods for assessing board and director performance.

- **Significant board events**: Disclose material changes to board composition, risk profile, or business strategy. Disclose material acquisitions/investment, or health/safety/environmental/cyber security incidents.

- **Recommendation 2.3: The OEB should set a disclosure framework that ensures high quality and timely reports, is not overly burdensome, and is aligned with other reporting or regulatory activities.**

  Rationale*: Disclosure can take a variety of forms. The OEB does not want reporting requirements to be onerous, but it also wants to ensure a high degree of transparency and accessibility. After reflecting on the stakeholder input Elenchus has concluded that the baseline reporting should be aligned with another reporting mechanism but that annual baseline reporting through the RRR would be more frequent than necessary. Elenchus concludes that the baseline disclosure should be filed as part of a cost of service or Custom IR proceeding, or other periodic reporting process. Any substantive changes during the IR period should be reported as part of the overall IR reporting process. The baseline information should also be posted on the utility's website, and it should be updated as necessary to reflect any substantive changes.*

  Elenchus concludes that this disclosure framework ensures transparency while minimizing the cost and regulatory burden by aligning the reporting with other regulatory processes.

Monitoring through baseline disclosure is an important tool, but additional analysis of corporate governance practices will assist the OEB to achieve its goals for this initiative. The OEB has indicated that it intends to develop assessment tools to further strengthen its utility corporate governance framework, and assessment is discussed in the next chapter.

9 ASSESSMENT

Assessment is the third component of the OEB's utility corporate governance framework (guidance and monitoring being the other two). While monitoring through disclosure is an important tool to support assessments, there are limitations on disclosure. A utility may be doing all the right things "on paper", but that does not ensure that there is a strong corporate governance culture or that there will be adherence to the spirit of the governance practices. Therefore, further assessment tools should be considered to determine whether there are areas that require further attention by the OEB. Periodic, risk-based assessments also uphold the spirit and intent of the guidance as a tool for continuous improvement.

This chapter sets out the Elenchus recommendations for assessing corporate governance. As in the prior sections on the Guidance and Monitoring, we start with a description of KPMG's recommendations and the OEB's objectives. We then provide a summary of the stakeholder input received in response to our draft recommendations. We reflect on that input and present our recommendations.

9.1 KPMG RECOMMENDATIONS

In its report, KPMG made the following recommendations:

> *The OEB should strive to ensure that its regulatory oversight for corporate governance provides substantive evidence that the LDCs are maturing in this regard and are in lockstep with leading practices. The OEB can consider the following alternatives:*
>
> - *Periodic independent assessment (e.g. 2-3 year cycle) of the LDCs corporate governance practices against leading practices and/or guidelines established by the OEB. The assessment should be risk based incorporating criteria that*

can assess the governance, operational, financial, regulatory and reputation risk that an LDC poses; and

- *An accreditation system by an independent accreditor organization that would assess the overall effectiveness of LDC corporate governance on a periodic basis. The accreditation model is common in the health care sector and can be used to measure an organization's capability in terms of operational effectiveness, health & safety and risk management as well.*[67]

Elenchus has considered these recommendations further and has incorporated the key ideas into our recommendations.

9.2 OEB Objectives

Elenchus understands that the OEB seeks to develop assessment tools to ensure that its regulatory oversight of corporate governance through the information filed with the OEB meets the expectations set out in its corporate governance guidance. Elenchus also understands that the OEB seeks to leverage the assessment of corporate governance within its broader regulatory framework.

9.3 Elenchus Recommendations

The OEB is concerned about the quality of corporate governance because of the importance of corporate governance for driving utility performance which serves to protect the interests of consumers and facilitate a financially viable sector. Corporate governance and utility performance are interdependent. The OEB's assessment of the quality of a utility's corporate governance will inform its review of the utility's business strategies and the investment plans underpinning its regulatory proposals. Likewise, the quality of a utility's regulatory proposals will be indicators of the strength of the utility's

[67] KPMG, *Review of Corporate Governance of Electricity Distributors*, Final Report, April 29, 2015, p. 45.

underlying corporate governance. Two approaches to assessment should be considered:

- For individual utilities, the OEB will be concerned with the quality of the disclosure and whether the corporate governance practices align with the OEB guidance.
- For the utility sector overall, the OEB will be concerned with best practices among utilities, signs of continuous improvement, and potential corporate governance gaps.

In assessing an individual utility's corporate governance practices against the OEB guidance and current best practice it will be relevant to consider a utility's performance over time, its performance in comparison with other utilities, and whether there are any gaps. The greatest value will come from assessing utility corporate governance on a proactive basis.[68] The OEB could use a risk-based approach for its assessments, both on an individual and systemic basis. Elenchus' recommendations have been developed with these principles in mind.

Stakeholder Input

(Stakeholder input is presented in italics. Elenchus' responses are presented in regular text.)

Stakeholders recognized the value of a gap analysis or an assessment of best practices, but were concerned about other potential consequences of an assessment. In the view of many stakeholders, the OEB already has sufficient assessment tools to review a utility's corporate governance if there is a concern about utility performance.

[68] The California Public Utilities Commission has initiated an investigation into PG&E's corporate governance. This is an example of reviewing corporate governance after the fact (in this case a major safety incident and evidence of ongoing issues). This sort of investigation is undoubtedly important after a major event, but by using effective monitoring and assessment tools the OEB has the opportunity to reduce the risk of poor corporate governance, and the negative consequences, on a proactive basis.

Elenchus concludes that there is value in the OEB conducting individual and systemic assessments of corporate governance practices.

For individual utilities, the OEB could conduct an assessment of corporate governance practices through a cost of service rebasing or Custom IR application process. However, alternative approaches for assessment separate from a rate proceeding may also be appropriate. In its draft recommendations Elenchus proposed that the OEB audit the disclosure filings for accuracy. We have removed that recommendation, because it unduly emphasizes a compliance approach to the overall process. Elenchus concludes that the emphasis should be on facilitating good corporate governance, establishing a disclosure framework, and encouraging continuous improvement, while respecting the voluntary nature of the guidance. As stakeholders have pointed out, the OEB has the ability to conduct an audit where warranted; it does not need to be emphasized in connection with this initiative.

For systemic reviews, Elenchus agrees with stakeholders that the OEB should take a strategic, or risk-based approach. The sector would benefit from an OEB assessment of the baseline corporate governance reporting which identified best practices or gaps because it would increase awareness for the purposes of education and continuous improvement. Beyond a best practice and/or gap review of the baseline data, the OEB should periodically assess in greater depth the corporate governance practices for certain key issues. These reviews should be strategic and risk-based, which can be done by using a set of criteria to determine which areas should be assessed in the review. Although the reviews would include additional disclosure in specific targeted areas, this could be done in a way which minimized the regulatory burden and addressed any confidentiality concerns. This was the type of reporting which raised concerns from stakeholders regarding confidentiality. Elenchus observes that the OEB's goal is to have monitoring and assessment which is more effective than just a "checklist" approach, and this appears to be the source of concerns about confidentiality. However, it is Elenchus' recommendation that the disclosure would be focused on the process and policies, not the content of the decisions. For example, the nature of the board assessment process (the structure, frequency, methods, etc.) and not the results of the assessment. Under this approach the disclosure would be consistent with the types of disclosure that reporting issuers are required to make already, and therefore concerns regarding board deliberations and confidential material should not arise.

In the draft report Elenchus proposed that the chair of the board could appear at a utility rate proceeding. Stakeholders opposed that proposal on the basis that it resulted in a blurring of the line between board responsibilities and management responsibilities. Elenchus has reconsidered the recommendation, and has concluded that it would not be the best approach to encourage alignment with the OEB's guidance and continuous improvement. We have concluded that alternative approaches, and in particular an OEB governance conference, would be a more effective tool.

Final Recommendations

- **Recommendation 3.1: The OEB should assess the corporate governance practices of individual utilities through the cost of service (or Custom IR) proceeding, or through some other process.**

  Rationale: *The OEB can use information about a utility's corporate governance practices to assist it in the rate-setting process. An assessment of a utility's corporate governance could be conducted as part of a cost of service or Custom IR rate application, or as part of a separate assessment process.*

- **Recommendation 3.2: The OEB should conduct periodic systemic assessments of governance practices against best practice and the OEB guidance.**

  The OEB should periodically (e.g. every two or three years) review the baseline disclosure information and identify best practices and high quality disclosure which could serve as benchmarks for others.

Rationale: *The CCGG recognizes that it cannot be inside the boardroom, and therefore must rely on other tools to assess the quality of corporate governance. Its annual guide to best practice presents specific examples of high quality disclosure. If the OEB were to provide a similar analysis, including highlighting where utilities have gone beyond the guidance, this would facilitate continuous improvement in the implementation and reporting of corporate governance practices.*

- **Recommendation 3.3: The OEB should conduct periodic systemic assessments of governance practices in key regulatory areas.**

Rationale: *The OEB will benefit from deeper understanding of the corporate governance practices in areas of greatest interest from a regulatory perspective, but should use a strategic and risk-based approach. To do this the OEB should identify the areas for assessment using a set of criteria such as:*

- *Potential impact on ratepayers*
- *Interaction with OEB policy development*
- *Trends in corporate governance practice in other sectors*

For example, the OEB may be particularly concerned with technology adaptation, related party transactions, financial management, system planning, strategy, or cyber security. It could use such assessments to strengthen corporate governance practices or to inform its development of regulatory policy. Part of the review could be to determine if there was evidence of improvement over time.

In applying a risk-based, criteria-driven approach to periodic reviews, the OEB should consider the following areas:

- **Risk management**: Assess the policies and practices for board consideration of risk, controls, mitigation, etc., with particular attention to enterprise risk management, financial management and cybersecurity risk.
- **Stakeholder interests**: Assess the policies and practices for considering the interests of stakeholders in key decisions (e.g. strategy, risk, major investments, dividends, etc.). Stakeholders include customers, debtholders, shareholders, employees, suppliers, etc.
- **Conflict of interest**: Assess the policies and practices for identifying and addressing potential conflicts of interest in key areas (e.g. dividends, affiliate transactions, non-utility activities, etc.)
- **Key regulatory issues**: Assess whether and how the board of directors engages on issues of key importance to the OEB's regulation (e.g. strategic plan, Distribution System Plan, rate proposals, cyber security).

Elenchus does not recommend that the OEB undertake systemic assessments in all of these areas at once. The OEB should consider these (and other) areas against a set of risk-based criteria and identify one area for review each year or two.

- **Recommendation 3.4: The OEB should have direct interaction with utility board directors through an open process.**

Elenchus recommends that the OEB convene a corporate governance conference every three years, which would provide an open forum for utility directors and senior executives to exchange views and ideas with the OEB and stakeholders

Rationale: *The OEB cannot see directly how a utility board of directors operates. By having a forum for direct interaction between the utility board of directors and* *the OEB the regulator can gain insight into the corporate governance culture, and the utility board of directors can have the opportunity to interact with the OEB in a transparent manner. "Off the record" discussions between the OEB and directors might be more candid, but would run counter to an approach emphasizing transparency. Elenchus concludes that significant value could still be obtained through a public corporate governance forum.*

- **Recommendation 3.5: The OEB should conduct a periodic review of the guidance to assess whether it is still current in terms of best practices and whether it is still aligned with the OEB's regulatory priorities.**

  Rationale: *Best practices in corporate governance continue to evolve, in response to industry practices, securities regulator requirements, and other drivers. It will be important for the OEB to review its guidance periodically to ensure it remains current. The guidance should also be reviewed in light of utility practices. New best practices may evolve, or systemic issues may emerge which the OEB could best address through refinements to the guidance. If this review were done every three years it could be coordinated with an OEB Governance Conference.*

APPENDIX 1: SUMMARY OF ELENCHUS RECOMMENDATIONS

GUIDANCE

- **Recommendation 1.1: The OEB guidance should be consistent with the principles in G20/OECD guidance, aligned with financial and securities regulator guidance, and consistent with the major sources for best practices in Canada, including ICD/Osler's *Directors' Responsibilities in Canada* and CCGG's *Building High Performance Boards*. The OEB should tailor its guidance to focus on the areas of greatest importance to regulated utilities and rate regulation.**

  Rationale*: This will align the OEB guidance with internationally recognized standards for good corporate governance and financial and securities sector guidance and reflect current best practices in Canada. This recognizes the common goals amongst regulators to foster good corporate governance and provides consistent guidance to utilities that are subject to securities regulator guidance. However, the OEB's mandate differs from that of securities and financial regulators in that the OEB has a broad public interest mandate and a specific objective to protect the interests of consumers. Therefore, the OEB's corporate governance guidance should align with the OEB's mandate and objectives. The OEB should develop its own guidance in order to recognize and address the particular characteristics of Ontario's regulated utilities and to address the specific areas of greatest focus for the OEB.*

- **Recommendation 1.2: The OEB guidance should be structured in accordance with the following principles:**

  - **Principle #1: The responsibilities of the board and of directors should be defined and transparent**: The board of directors is responsible for setting the utility's strategy, overseeing the risk of the utility, monitoring the financial and operational performance of the utility, and selecting and evaluating the CEO.

- **Principle #2: Directors should exercise their independent judgment in the best interests of the utility with appropriate balance given to the interests of customers**: Directors must be skilled in a variety of areas (including technical skills such as legal, engineering, accounting, and regulatory, and governance skills such as integrity, collegiality, and strategic thinking) and committed to the long-term best interests of the utility, including balancing the interests of customers and shareholders. They must be able to challenge management while working cooperatively in the long-term best interests of the utility.

- **Principle #3: The structure of the board should support the effective and efficient operation of the board as it fulfills its responsibilities, particularly the exercise of independent business judgment in the best interests of the utility**: The roles and responsibilities of the board, the committees and the individual directors must be clear and robust. The structure of the board may vary, depending upon factors such as the complexity of the business and the overall corporate structure.

- **Principle #4: The board should adopt policies and practices which facilitate high performance and which ensure that the conduct of the board meets the highest standards of skill, integrity, and diligence**: The directors (and the board as a whole) must conduct themselves with the highest integrity, using the appropriate tools to govern conflict of interest, risk, strategy, stakeholder interests, communications, and assessment. They must have the policies and practices in place to support high performance and continuous improvement.

***Rationale**: This approach provides an overall structure which recognizes four key principles of corporate guidance from a regulatory perspective. The quality of utility corporate governance is an important factor in maintaining the confidence of customers and regulators, shareholders and debt holders, as well being an important indicator of financial integrity. The OEB guidance should therefore draw attention to specific areas of corporate governance that are especially important for utilities, owing to the unique nature and circumstances of utilities, their ownership structures, and the risks assumed relative to other corporations. However, the guidance should be consistent with established best practices, as reflected in a variety of expert external sources, and be flexible to recognize that specific approaches may vary depending upon the particular circumstances.*

The Draft Guidance includes provisions related to director independence, conflict of interest, risk, strategy, stakeholder interests, communication, and assessment.

MONITORING

- **Recommendation 2.1: The OEB should implement disclosure requirements for baseline utility corporate governance information.**

  ***Rationale**: The importance of disclosure has been recognized by financial and securities regulators, as well as by external organizations like the Canadian Coalition for Good Governance (which represents large institutional shareholders). Disclosure enhances transparency around governance practices, itself a characteristic of good corporate governance, and aids assessment by* *external parties. Under the Canadian "principles-based" approach to securities regulation (with the exception of mandatory rules relating to audit committees), a company is required to publicly disclose the extent to which it meets the identified best practices and, where its practices differ from the guidelines, to describe how its practices meet the same corporate governance objectives.*

Under this approach, each utility would disclose its corporate governance practices and whether they align with the OEB guidance. To the extent a utility's corporate governance practices differed from the guidance, then the utility would explain whether and how its approach achieves the principles set out in the OEB guidance.

Elenchus proposed a formal self-assessment or self-certification process in its draft recommendations, but we have removed that from our final recommendations. Elenchus concludes that effective baseline disclosure (including analysis of the alignment with the OEB's guidance) along with periodic updates for changes, will accomplish the same objective at this time. This approach is more light-handed and is consistent with the voluntary nature of the guidance. The OEB may wish to revisit the idea of formal self-assessment/self-certification at a later time.

- **Recommendation 2.2: The baseline reporting should include disclosure of corporate governance practices in each of the areas identified in the guidance, and should include reporting in specific areas of interest from a regulatory perspective.**

***Rationale**: As has been recognized by OSFI, it is relatively easy to monitor (and assess) the structural elements of corporate governance, but it is harder to* *monitor (and assess) the behavioural elements of corporate governance. CCGG makes a similar observation in commenting that it cannot observe directly what goes on in the corporate boardroom. The challenge for regulators is to identify the information that can assist in identifying areas of concern or risk which may exist within the utility.*

KPMG recommended that the OEB assess and understand the potential drivers facing utilities which might lead to increased risk-taking or other adverse behaviour. KPMG recommended that the OEB monitor significant changes to board composition, risk profile, business strategy, acquisitions/investment, or health/safety/environmental incidents. Elenchus has included these areas, but believes that the OEB should also consider other information, as these indicators alone may not be sufficient. For example, KPMG recommended that the OEB be advised of any substantial changes in strategy. However, given the pace of technological change in the sector, significant risks may arise if a utility does ***not*** *change its business strategy in response to changing technology.*

Elenchus therefore recommends specific baseline disclosure in some areas which are of particular relevance to the OEB, given its statutory mandate and the state of utility sector. The following disclosures are recommended as part of the baseline reporting:

- **Board responsibilities**: Disclose all Unanimous Shareholder Agreements or Sole Shareholder Declarations. This will show the extent of the decision-making authority of the utility board of directors. Disclose the mandates and/or charters for the board and each of the committees.
- **Director independence**: Disclose the name of each director and whether he/she is independent and the criteria used to determine independence and whether he/she is a councillor or employee of a municipal

shareholder. If the majority of the board is not independent, provide an explanation of how the board maintains independent judgment.

- **Director selection**: Disclose the necessary qualifications (e.g. the skills matrix) and selection process, including considerations of gender and diversity. Disclose orientation, education and development practices. Disclose the attendance record of directors (including committees).
- **Board assessment**: Disclose the methods for assessing board and director performance.
- **Significant board events**: Disclose material changes to board composition, risk profile, or business strategy. Disclose material acquisitions/investment, or health/safety/environmental/cyber security incidents.

- **Recommendation 2.3: The OEB should set a disclosure framework that ensures high quality and timely reports, is not overly burdensome, and is aligned with other reporting or regulatory activities.**

***Rationale**: Disclosure can take a variety of forms. The OEB does not want reporting requirements to be onerous, but it also wants to ensure a high degree of transparency and accessibility. After reflecting on the stakeholder input Elenchus has concluded that the baseline reporting should be aligned with another reporting mechanism but that annual baseline reporting through the RRR would be more frequent than necessary. Elenchus concludes that the baseline disclosure should be filed as part of a cost of service or Custom IR proceeding, or other periodic reporting process. Any substantive changes during the IR period should be reported as part of the overall IR reporting process. The baseline information should also be posted on the utility's website, and it should be updated as necessary to reflect any substantive changes.*

Elenchus concludes that this disclosure framework ensures transparency while minimizing the cost and regulatory burden by aligning the reporting with other regulatory processes.

ASSESSMENT

- **Recommendation 3.1: The OEB should assess the corporate governance practices of individual utilities through the cost of service (or Custom IR) proceeding, or through some other process.**

  Rationale: *The OEB can use information about a utility's corporate governance practices to assist it in the rate-setting process. An assessment of a utility's corporate governance could be conducted as part of a cost of service or Custom IR rate application, or as part of a separate assessment process.*

- **Recommendation 3.2: The OEB should conduct periodic systemic assessments of governance practices against best practice and the OEB guidance.**

  The OEB should periodically (e.g. every two or three years) review the baseline disclosure information and identify best practices and high quality disclosure which could serve as benchmarks for others.

  Rationale: *The CCGG recognizes that it cannot be inside the boardroom, and therefore must rely on other tools to assess the quality of corporate governance. Its annual guide to best practice presents specific examples of high quality disclosure. If the OEB were to provide a similar analysis, including highlighting where utilities have gone beyond the guidance, this would facilitate continuous improvement in the implementation and reporting of corporate governance practices.*

- **Recommendation 3.3: The OEB should conduct periodic systemic assessments of governance practices in key regulatory areas.**

  Rationale: *The OEB will benefit from deeper understanding of the corporate governance practices in areas of greatest interest from a regulatory perspective, but should use a strategic and risk-based approach. To do this the OEB should identify the areas for assessment using a set of criteria such as:*

  - *Potential impact on ratepayers*
  - *Interaction with OEB policy development*
  - *Trends in corporate governance practice in other sectors*

  For example, the OEB may be particularly concerned with technology adaptation, related party transactions, financial management, system planning, strategy, or cyber security. It could use such assessments to strengthen corporate governance practices or to inform its development of regulatory policy. Part of the review could be to determine if there was evidence of improvement over time.

  In applying a risk-based, criteria-driven approach to periodic reviews, the OEB should consider the following areas:

  - **Risk management**: Assess the policies and practices for board consideration of risk, controls, mitigation, etc., with particular attention to enterprise risk management, financial management and cybersecurity risk.
  - **Stakeholder interests**: Assess the policies and practices for considering the interests of stakeholders in key decisions (e.g. strategy, risk, major investments, dividends, etc.). Stakeholders include customers, debtholders, shareholders, employees, suppliers, etc.
  - **Conflict of interest**: Assess the policies and practices for identifying and addressing potential conflicts of interest in key areas (e.g. dividends, affiliate transactions, non-utility activities, etc.)

- **Key regulatory issues**: Assess whether and how the board of directors engages on issues of key importance to the OEB's regulation (e.g. strategic plan, Distribution System Plan, rate proposals, cyber security).

Elenchus does not recommend that the OEB undertake systemic assessments in all of these areas at once. The OEB should consider these (and other) areas against a set of risk-based criteria and identify one area for review each year or two.

- **Recommendation 3.4: The OEB should have direct interaction with utility board directors through an open process.**

Elenchus recommends that the OEB convene a corporate governance conference every three years, which would provide an open forum for utility directors and senior executives to exchange views and ideas with the OEB and stakeholders

Rationale: *The OEB cannot see directly how a utility board of directors operates. By having a forum for direct interaction between the utility board of directors and the OEB the regulator can gain insight into the corporate governance culture, and the utility board of directors can have the opportunity to interact with the OEB in a transparent manner. "Off the record" discussions between the OEB and directors might be more candid, but would run counter to an approach emphasizing transparency. Elenchus concludes that significant value could still be obtained through a public corporate governance forum.*

- **Recommendation 3.5: The OEB should conduct a periodic review of the guidance to assess whether it is still current in terms of best practices and whether it is still aligned with the OEB's regulatory priorities.**

Rationale: *Best practices in corporate governance continue to evolve, in response* *to industry practices, securities regulator requirements, and other drivers. It will be important for the OEB to review its guidance periodically to ensure it remains current. The guidance should also be reviewed in light of utility practices. New best practices may evolve, or systemic issues may emerge which the OEB could best address through refinements to the guidance. If this review were done every three years it could be coordinated with an OEB Governance Conference.*

APPENDIX 2: OEB STATUTORY OBJECTIVES

Board objectives, electricity

The Board, in carrying out its responsibilities under this or any other Act in relation to electricity, shall be guided by the following objectives:

1. To protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.

1.1 To promote the education of consumers.

2. To promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry.
3. To promote electricity conservation and demand management in a manner consistent with the policies of the Government of Ontario, including having regard to the consumer's economic circumstances.
4. To facilitate the implementation of a smart grid in Ontario.
5. To promote the use and generation of electricity from renewable energy sources in a manner consistent with the policies of the Government of Ontario, including the timely expansion or reinforcement of transmission systems and distribution systems to accommodate the connection of renewable energy generation facilities.

Board objectives, gas

The Board, in carrying out its responsibilities under this or any other Act in relation to gas, shall be guided by the following objectives:

1. To facilitate competition in the sale of gas to users.
2. To protect the interests of consumers with respect to prices and the reliability and quality of gas service.
3. To facilitate rational expansion of transmission and distribution systems.
4. To facilitate rational development and safe operation of gas storage.
5. To promote energy conservation and energy efficiency in accordance with the policies of the Government of Ontario, including having regard to the consumer's economic circumstances.

5.1 To facilitate the maintenance of a financially viable gas industry for the transmission, distribution and storage of gas.

6. To promote communication within the gas industry and the education of consumers.

APPENDIX 3: OEB CORPORATE GOVERNANCE FILING REQUIREMENTS

(Note: These filing requirements are no longer in force.)

Under earlier filing requirements, electricity distributors filing a cost of service rebasing or Custom IR application were required to provide the following:

Corporate and utility organizational structure, showing the main units and executive and senior management positions within the utility. Include any planned changes in corporate or operational structure (including any changes in legal organization and control) and rationale for organizational change and the estimated cost impact, including the following;

- Corporate entities relationship chart, showing the extent to which the parent company is represented on the utility company board; and
- The reporting relationships between utility management and parent company officials.

In addition, the following information must be filed:

Board of Directors

- The number of board members and how many are independent. State whether or not there is a policy on the number or proportion of independent directors; and
- A description of what the board of directors does to facilitate its exercise of independent judgment in carrying out its responsibilities.

Board Mandate

- The text of the board's written mandate. If the board does not have a written mandate, describe how the board delineates its role and responsibilities.

Board Meetings

- A schedule of the meetings of the Board in the current fiscal year (2014 for 2015 COS filers).

Orientation and Continuing Education

- A description of what measures, if any, the board takes to provide continuing education for its directors. If the board does not provide continuing education, describe how the board ensures that its directors maintain the skill and knowledge necessary to meet their obligations as directors.

Ethical Business Conduct

- A statement as to whether or not the board has adopted a written code for the directors, officers and employees. If the board has adopted a written code provide a copy of the code; and describe how the board monitors compliance with its code, or if the board does not monitor compliance, explain whether and how the board satisfies itself regarding compliance with its code.

Nomination of Directors

- A description of the process by which the board identifies and selects new candidates for nomination to the board of directors.

Board Committees

- Identification of any committees of the Board;
- For each committee identified:
    - a description of the functions of the committee; and
    - the text of the charter for the committee, if one exists.
- If there is an audit committee, a statement as to whether or not the members of the committee are
    - independent; and
    - financially literate.

APPENDIX 4: SELECTED RESOURCES

Financial and Securities Regulators and Government

- Office of the Superintendent of Financial Institutions (OSFI)
  OSFI's Guidance for federally-regulated financial institutions: http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/gl-ld/pages/cg_guideline.aspx

- Ontario Securities Commission
  1) *National Instrument 58-101 Disclosure of Corporate Governance Practices*: http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20050617_58-101_disc-corp-gov-pract.jsp
  2) Select Amendments: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20141211_58-101_amd-governance-practices.htm
  3) *National Policy 58-201 Corporate Governance Guidelines*: http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20050617_58-201_corp-gov-guidelines.jsp
  4) *Consolidation (unofficial) of National Instrument 52-110 Audit Committees*: http://www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20101210_52-110_unofficial-consolidated.pdf

- Ontario Distribution Sector Review Panel, *Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First*: http://www.energy.gov.on.ca/en/files/2012/05/LDC_en.pdf

- Report of the Special Advisor on Agencies (Burak Report), December 20, 2010
  https://dr6j45jk9xcmk.cloudfront.net/documents/2031/burak-report-on-agencies.pdf

- BC Crown Agencies Resource Office - http://www2.gov.bc.ca/gov/content/governments/organizational-structure/ministries-organizations/central-government-agencies/crown-agencies-resource-office
  Sample Guidance: *Governance and Disclosure Guidelines for Governing Boards of British Columbia Public Sector Organizations (Best Practice Guidelines*) establish broad provincial standards for board governance practices, and provide for greater public accountability and transparency through standardized disclosure requirements. http://www.brdo.gov.bc.ca/governance/corporateguidelines.pdf

- Alberta Public Agencies Governance Act: http://www.qp.alberta.ca/documents/Acts/A31P5.pdf

Law, Consulting, Accounting and other Organizations

- Aird & Berlis - Webinar on corporate governance for LDCs (archive recording): http://sites.airdberlis.vuturevx.com/80/741/compose-email/follow-up-and-archive---corporate-governance-for-ldcs--what-senior-managers-and-municipal-shareholders-need-to-know---thursday--january-28--2016.asp

- Canadian Coalition for Good Governance (institutional shareholders): http://www.ccgg.ca/
  - *2015 Best Practices*: http://www.ccgg.ca/site/ccgg/assets/pdf/2015_best_practices.pdf
  - *Building High Performance Boards*: http://www.ccgg.ca/site/ccgg/assets/pdf/building_high_performance_boards_august_2013_v12_formatted__sept._19,_2013_last_update_.pdf
  - *Governance Differences of Equity Controlled Corporations:* http://www.ccgg.ca/site/ccgg/assets/pdf/Gov_Differences_of_Equity_Controlled_Corps_FINAL_Formatted.pdf

- CPA Canada – a variety of resources for directors. e.g. https://www.cpacanada.ca/search-results?#q=resources%20for%20directors

- E&Y - Center for Board Members: http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-center-for-board-matters
  Adding value: A guide for boards and HR committees in addressing human capital risks and opportunities: http://www.ey.com/Publication/vwLUAssets/Adding-value-boards-HR-human-capital-risks/$FILE/EY-Adding-value-boards-HR-human-capital-risks.pdf

- Globe and Mail "Board Games" Methodology: http://v1.theglobeandmail.com/v5/content/boardgames/methodology-corporations.html

- Carol Hansell, ***What Directors Need to Know: Corporate Governance***, Thomson Carswell, 2003

- Richard Leblanc, ***The Handbook of Board Governance***, Wiley, 2016

- *TSX Guide to Good Disclosure for National Instrument 58-101 Disclosure of Corporate Governance Practices (NI 58-101) and Multilateral Instrument 52-110 – Audit Committees (MI 52-110),* January 2006: http://apps.tmx.com/en/pdf/TSXGuideToGoodDisclosure.pdf

- Weir Foulds, *Governance Issues for Municipalities and their LDCs,* Presentation by Robert Warren, February 27, 2014: http://www.thinkingpower.ca/PDFs/OwnOrNot/Conference%20Presentation%20-%20Governance%20Issues%20for%20Municipalities%20and%20their%20LDCs%20-

%20Robert%20Warren%20and%20Daniel%20Ferguson,%20WeirFoulds%20LLP.pdf

- Guy Holburn, *Guidelines for Governance of the Electricity Sector in Canada,* the Council for Clean and Reliable Electricity, the Richard Ivey School of Business, University of Western Ontario and the University of Waterloo, January 2011.

Directors' Organizations

- Institute of Corporate Directors (Canada): https://www.icd.ca/Home.aspx
  Directors' Responsibilities in Canada (with Osler, Hoskin and Harcourt LLP): https://www.icd.ca/getmedia/581897ca-d69d-4d4f-a2a2-ca6b06ef223b/5467_Osler_Directors_Responsibilities_-Canada-FINAL.pdf.aspx

- The Directors College: http://thedirectorscollege.com/

International Sources

- Financial Reporting Council - UK Corporate Governance Code: https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

- G20/OECD Principles of Corporate Governance: http://www.oecd-ilibrary.org/docserver/download/2615021e.pdf?expires=1456351996&id=id&accname=guest&checksum=D5362DB164438F7D6555733B24E5179F

- OECD Guidelines on Corporate Governance of State-Owned Enterprises 2015 edition: http://www.oecd-ilibrary.org/docserver/download/2615061e.pdf?expires=1456351752&id=id&accname=guest&checksum=BA32BB294077525BD08FEB5810FA3EF8

- Global Network of Director Institutes: http://www.gndi.org/

Guiding Principles of Good Governance:
http://gndi.weebly.com/uploads/1/4/2/1/14216812/2015_may_6_guiding_principles_of_good_governance.pdf

APPENDIX 5: LIST OF PARTICIPANTS IN STAKEHOLDER SESSIONS

UTILITIES

Enbridge Gas Distribution

Andrew Mandyam, Director Regulatory Affairs and Financial Performance

Allison Ferreir, Associate General Counsel and Corporate Secretary

Tania Persad, Senior Legal Counsel

Goderich Hydro

Larry McCabe, President & CEO

Greater Sudbury Utilities

Mark Signoretti, Board Chair

Frank Kallonen, President & CEO

Lorella Hayes, VP Corporate Services & CFO

Hydro One

David Denison, Board Chair

Mayo Schmidt, President & CEO

Karen Taylor, Senior Director

Lakeland Power

Phil Matthews, Board Chair

Chris Litschko, CEO

Bruce Flowers, Governance Committee Chair

London Hydro

Mohan Mathur, Board Chair

Vinay Sharma, CEO

PowerStream

Dennis Nolan, EVP Corporate Services & Secretary

Colin Macdonald, SVP Regulatory Affairs & Customer Service

Ontario Power Generation

Jeff Lyash, President & CEO

Catriona King, VP Corporate Secretary

Carlton Mathias, Assistant General Counsel

Bryan Icyk, Senior Manager Regulatory Affairs

Ottawa Hydro

Greg Van Dusen, Director Regulatory Affairs

Thunder Bay Hydro

Gary Armstrong, Board Chair

Robert Mace, President & CEO

Toronto Hydro

Amanda Klein, VP Regulatory Affairs and General Counsel

Conrad Sheppard, Director Legal Services and Corporate Secretary

Union Gas Limited

Steve Baker, President & CEO

Mark Kitchen, Director Regulatory Affairs

Dave Simpson, VP In-Franchise Sales and Marketing and Customer Care

Utilities Kingston

Jim Keech, President & CEO

INTERVENORS

Consumers Council of Canada

Ken Whitehurst, Executive Director

Energy Probe

Roger Higgin, Consultant

David McIntosh, Consultant

Schools Energy Coalition

Jay Sheppard, Counsel

Vulnerable Energy Consumers Coalition

Michael Jannigan, Counsel