



34 King Street East, Suite 600
Toronto, Ontario, M5C 2X8
elenchus.ca

Corporate Governance for Regulated Natural Gas and Electricity Utilities

**A DRAFT Report Prepared by
Elenchus Research Associates Inc.
for the Ontario Energy Board**

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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 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 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).

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

- Set the framework for stakeholder consultations on the OEB guidance, and the monitoring and assessment tools
- Present recommendations for the OEB guidance, monitoring and assessment (including a *Preliminary 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. However, we have not yet conducted consultations with stakeholders. We believe that an important part of the process is to gain insights directly from the stakeholders. This report is therefore a **draft**. After this draft report is released (including the Elenchus *Preliminary Draft Guidance*), the OEB will conduct a number of stakeholder sessions in order to engage stakeholders on the principles and recommendations contained in this draft report and to gather feedback.

Elenchus will reflect on the discussion and input gathered through the stakeholder sessions and will finalize this report and prepare *Draft Guidance*, which we will provide to the OEB. In our final report we will explain how the stakeholder input helped shape our thinking.

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.

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. The *Preliminary Draft Guidance* is found in Appendix 1.
8. Monitoring: Presents Elenchus' recommendations for monitoring utility performance against the OEB guidance.
9. Assessment: Presents Elenchus' recommendations for assessing utility corporate governance performance.
10. Next steps: Identifies intended next steps for stakeholder consultation.

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.³ The OEB has also taken more direct action in response to a demonstrated need. In the 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.

³ *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 focussed 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.⁴

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.

⁴ *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.⁵

New provisions in the *OEB Act* have also increased the focus on utility corporate governance. The *OEB Act* 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*.⁶*

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, particularly for utilities. These provisions also set a specific standard against which the OEB could choose to exercise its enforcement provisions. For example, the OEB could

⁵ Ibid., p. 38.

⁶ Ontario Energy Board Act, 1998, s. 125.2.

require utilities to demonstrate what measures their directors and officers have taken to fulfill their duty of care and/or compliance with legislation.⁷

This direct focus on utility corporate governance through the legislation complements the evolution of the OEB's interest in the subject. Whereas historically the OEB was focussed on corporate governance in specific situations (e.g. affiliate relationships), the OEB is now focussed on 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 2012.⁸ At its heart, the RRFE is about utility performance and delivering better value to customers. Past regulatory reviews focussed 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,

⁷ Increased penalty provisions have also been enacted. The maximum administrative penalty for contravening an enforceable provision has increased from \$20,000 per day to \$1 million per day. Maximum fines for officers and directors convicted of an offence under the *OEB Act* have doubled from \$50,000 to \$100,000 for a first offence, and from \$150,000 to \$300,000 for a subsequent offence. The maximum fines for corporations convicted of an offence under the *OEB Act* have increased from \$250,000 to \$1 million for a first offence, and from \$1 million to \$2 million for a subsequent offence

⁸ *Report of the Board - Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach*, Ontario Energy Board, October 18, 2012.

including rate options (custom IR and Revenue Cap IR), transmission system plans, customer engagement, scorecards and benchmarking.⁹ Natural gas utilities have adapted the principles of Custom IR in order to craft their own proposals. The OEB has recently announced that it will update its filing requirements for natural gas rate applications to incorporate the key principles of the RRFE.¹⁰ Ontario Power Generation has recently 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.¹¹

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

⁹ *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.

¹⁰ *Filing Requirements for Natural Gas Distributor Rate Applications OEB File No. EB-2016-0033*, letter from the OEB, March 7, 2016.

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

*philosophy around how compensation is established and its relationship to utility performance...rather than the details as to how much individual employees are paid.*¹²

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.*¹³

As an initial step, the OEB instituted filing requirements around corporate governance practices. These filing requirements are set out in Appendix 4.

The role of corporate governance within the regulatory framework is evolving. The OEB is driven 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 striving to achieve these goals with the most efficient and effective regulatory process possible. 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. 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.

¹² *Performance based regulation seen through the customers' lens*, Remarks for the Ontario Energy Association, Energy Conference, Toronto, September 11, 2013.

¹³ *Update to Chapters 1, 2 and 3 of the Filing Requirements for Electricity Distribution Rate Applications*, cover letter from the OEB, July 17, 2013.

The OEB has determined 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.

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 3.
- *Facilitate achievement of the four performance outcomes under the Renewed Regulatory Framework:* The RRFE is focussed on delivering improved outcomes for customers in four areas: customer focus, operational effectiveness, public policy responsiveness, and financial performance.

In the next chapter we establish 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 *Preliminary 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/OECD¹⁴ *Principles on 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.*¹⁵

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."¹⁶

¹⁴ The Organisation for Economic Co-operation and Development

¹⁵ G20/OECD Principles of Corporate Governance, 2015, p. 9.

¹⁶ 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.¹⁷

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.

¹⁷ 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 regulated utilities, 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 they operate 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*¹⁸ on financial statements, information provided by management, and/or advice provided by qualified external advisors.¹⁹

¹⁸ *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.

¹⁹ 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 compliance obligations in this report. Readers are encouraged to review the various sources of information, and/or seek legal advice regarding these matters.²⁰

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:

²⁰ 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 can 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 identify 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 5. 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 and for 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.²¹

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 which had resulted. The companies were subsequently declared bankrupt. The trustee

²¹ *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461, 2004 SCC 68.

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.²²

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 repeating that perfection is not demanded. Courts are ill-suited and should be

²² Ibid. para. 35.

*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.*²³

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.²⁴

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.

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

²³ Ibid. para. 67.

²⁴ *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69.

(among others things) that their interests had been disregarded or were not adequately taken into account. The Court refers to its decision in an earlier case 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.²⁵

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 treat affected stakeholders in a fair manner, commensurate with the corporation's duties as a responsible corporate citizen.²⁶

²⁵ BCE, para. 39.

²⁶ BCE, para. 82

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* goes further in setting out the director's duty. The decision also confirms the OEB's jurisdiction to take action in 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.²⁷ 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 independent directors before declaring any dividends."²⁸ 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

²⁷ *Toronto Hydro-Electric System Limited v. Ontario Energy Board*, 2010 OCA 284 (April 20, 2010)

²⁸ *Ibid.*, para. 11.

subjective and open-ended grant of power to enable the OEB to engage in the impugned inquiry in the course of rate setting.”²⁹

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.*³⁰

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 corporate law principles within the context of its objectives; this implies a reasonableness standard.*³¹

²⁹ Ibid. para. 29.

³⁰ Ibid. para. 50.

³¹ Ibid. para. 41.

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 broad 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.³² 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.

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

³² 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%.

person who can say ‘Yes’ or ‘No’ as the occasion requires (or to put it another way, as the corporation requires).”³³

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...*³⁴

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.

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

³³ 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.)

³⁴ 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.)

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.*³⁵

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."

This case demonstrates the care which directors must apply in situations where they hold multiple directorships or other positions which may create potentially conflicting

³⁵ *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.*, [1993] O.J. No. 1793 (C.A.).

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.³⁶

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

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 transactions. Indeed, it would generally be impossible for him to do so, regardless 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

³⁶ Brant Investments Ltd. v. KeepRite Inc., 1991 CANLII 2705 (ON CA)

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, aim to “provide a robust but flexible reference for policy makers and market participants to develop their own frameworks for corporate governance.”³⁷

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):

³⁷ 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 2015.³⁸ 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.”³⁹ 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.”⁴⁰ 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.”⁴¹

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

³⁸ *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, 2015 Edition,

³⁹ *OECD Guidelines*, p. 7.

⁴⁰ *OECD Guidelines*, p. 24.

⁴¹ *OECD Guidelines*, p. 26.

- 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 follow 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.⁴²

These national guidelines and requirements provide guidance which is directly applicable to Ontario's regulated natural gas and electricity utilities and provides strong 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."⁴³ 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 responsibilities⁴⁴

⁴² *National Instrument 52-110 Audit Committees* (see, for example, January 1, 2011 Unofficial Consolidation)

⁴³ Office of the Superintendent of Financial Institutions (OSFI) *Guideline* (Corporate Governance, Sound Business and Financial Practices), January 2013.

⁴⁴ 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 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.*⁴⁵

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

⁴⁵ OSFI Guideline, p. 4.

agencies.⁴⁶ 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.⁴⁷

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 5. 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

⁴⁶ *Alberta Public Agencies Governance Act*, 2009.

⁴⁷ *Report of the Special Advisor on Agencies*, Rita Burak, December 20, 2010.

principles when it assesses the governance practices of Canadian public companies, 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 5.

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. 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.⁴⁸ 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

⁴⁸ 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. The third largest gas utility (Natural Resource Gas) is privately owned.

These various ownership structures can present unique 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.⁴⁹

⁴⁹ OECD Guidelines, p. 12.

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 *Business Corporations Act (Ontario)*; 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 municipal shareholder, and particularly if there is more than one municipal shareholder. 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.

This concern is particularly acute where the director appointed by the municipal shareholder is a municipal employee or councillor. Under municipal law, 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. This challenge can be avoided if councillors are not appointed to the distributor board. In any event, the board and its directors must be informed of this

potential for 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 and what practices will be adopted to ensure the directors fulfill their fiduciary duty and duty of care.

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.

Investor-owned utilities in Ontario are generally the subsidiaries of larger Canadian or international corporations. As a result, some of the same types of concerns described above can arise, and in particular concerns about real or potential conflict of interest involving affiliated entities.

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 level, rather than by the board of

the regulated utility.⁵⁰ 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 or directly with the shareholders) effectively reduces the board's independence which could 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 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. The next chapter sets out Elenchus' approach to developing a preliminary draft of the OEB guidance.

⁵⁰ The OEB guidance will be directed at corporate governance at the level of the regulated utility, not the holding company.

7 OEB GUIDANCE

The OEB has commissioned Elenchus to develop draft guidance on corporate governance for Ontario's regulated natural gas and electricity utilities. Our preliminary version of this guidance is attached as Appendix 1 (*Preliminary Draft Guidance*). Elenchus intends to discuss this *Preliminary Draft Guidance* with stakeholders in the stakeholder sessions. After those discussions, Elenchus will prepare the *Draft Guidance*, to be included with the final version of this report. Elenchus believes that it is particularly important to understand the views, concerns, and proposals of stakeholders as we go through the process of developing *Draft Guidance* for the OEB. This section describes the overall approach that Elenchus has taken to develop the *Preliminary Draft Guidance* included as part of this draft report.

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 of the 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 distributor 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.*⁵¹

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

⁵¹ 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 *Preliminary Draft Guidance*.

7.2 OEB OBJECTIVES

The OEB 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 requirements 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 *Preliminary Draft Guidance* is based on Elenchus' expertise and experience and is designed to achieve these key OEB objectives. The next section sets out the overall approach.

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, the OEB is working proactively to protect the interests of consumers, promote efficiency and effectiveness and facilitate a financially viable sector.⁵² 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

⁵² 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.

recognized, good corporate governance is the combination of structures and processes 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 an appropriate level of 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.⁵³

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 based on financial and securities regulator guidance.**

Rationale: This will align OEB and financial and securities sector guidance. This recognizes the common goals amongst regulators and provides consistent guidance to utilities that are subject to securities regulator guidance. The OEB should tailor its guidance to focus on the areas of greatest importance to public

⁵³ *Directors' Responsibilities in Canada*, Osler, Hoskin & Harcourt LLP and Institute of Corporate Directors, October 2014.

utilities and rate regulation. An alternative would be to simply adopt existing financial and/or securities regulator guidance. Elenchus recommends that the OEB develop its own guidance (based on these other regulators' guidance) in order to recognize and address the particular characteristics of Ontario's natural gas and electricity utility sector and to address the specific areas of greatest focus for the OEB. Securities guidance contains a significant amount of detail. By focusing on areas of greatest relevance for OEB regulation, the OEB guidance can be streamlined in a number of areas (i.e. contain fewer provisions). More detail would be provided in areas of particular concern to the OEB, including independence, board decision-making, and risk. See Recommendation 1.4 for more detail.

- **Recommendation 1.2: The OEB guidance should be consistent with the principles in G20/OECD 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*.**

Rationale: This will align the OEB guidance with internationally recognized standards for good corporate governance and reflect current best practices in Canada.

- **Recommendation 1.3: The OEB guidance should address the following areas:**
 - **Responsibilities:** The board of directors is responsible for setting the corporation's strategy, overseeing the risk of the corporation, monitoring the financial and operational performance of the corporation, and selecting and evaluating the CEO. These core responsibilities must be undertaken by skilled directors, based on a robust structure and with conduct of the

highest integrity.

- **Directors:** 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 corporation. They must be able to challenge management while working cooperatively in the best long-term interests of the corporation.
- **Structure:** The roles and responsibilities of the board, the committees and the individual directors must be clear and robust.
- **Conduct:** The individual directors (and the board as a whole) must conduct themselves with the highest integrity, using the appropriate tools to govern communications, conflicts and relationships and to set, evaluate and improve individual and overall performance.

Rationale: This approach provides an overall structure which recognizes the four key elements of corporate guidance. The specific guidance in each area is set out in greater detail in Appendix 1: *Preliminary Draft Guidance*.

- **Recommendation 1.4: The OEB guidance should include more detailed provisions in specific areas of greatest concern to the OEB.**

Rationale: 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. This approach would distinguish the OEB guidance from other sector guidance by focussing on the areas of greatest concern to the OEB. However, the guidance would be consistent with established best practices, as reflected in a variety of expert external sources.

This approach would position the OEB as a leader in setting effective corporate governance for public utilities, recognizing the duty of public utilities to their ratepayers and reflecting the ownership structures in Ontario. The criteria for determining which areas should be included could be:

- 1) Significance of the issue in terms of OEB regulation
- 2) Significance of the issue in terms of corporate governance generally
- 3) Relevance of the issue in terms of the ownership structures of Ontario's utilities

The *Preliminary Draft Guidance* includes targeted provisions related to director independence (including some options), board decision making and conflict of interest.

The OEB guidance is the first part of a three-part approach to corporate governance contemplated by the OEB. The OEB 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.

8 MONITORING

Once the OEB has established its guidance for corporate governance, it will be important to monitor utility performance. Monitoring will provide greater transparency of utility corporate governance practices and assist the OEB with assessing whether utility corporate governance practices are meeting the OEB's expectations and achieving 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 our recommendations. Elenchus intends to discuss these recommendations with stakeholders in the stakeholder sessions. After those discussions, Elenchus will consider the input of stakeholders and prepare a final version of this report, along with our final recommendations for monitoring.

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.*⁵⁴

Elenchus believes that these can be useful indicators within a broader, more holistic approach to monitoring, based on thorough 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 must truly 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. Disclosure is also one of the key components of the OEB's overall regulatory approach which involves setting standards, performance reporting against those standards, and

⁵⁴ KPMG, *Review of Corporate Governance of Electricity Distributors*, Final Report, April 29, 2015, p. 45-46.

assessment of the performance.⁵⁵ The OEB has required some disclosure of corporate governance information through its filing requirements (see Appendix 4).

Elenchus sets out a number of recommendations below. Recommendations 2.1, 2.2., and 2.3 relate specifically to what information should be disclosed. These recommendations would replace (or modify) the current filing requirements. Recommendation 2.4 relates specifically to how disclosure should be done.

- **Recommendation 2.1: Implement disclosure requirements aligned with the OEB guidance.**

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 complies with the identified best practices and, where its practices differ from the guidelines, to describe how its practices meet the same corporate governance objectives. This approach is commonly referred to as “comply or disclose”.

Under this approach, each utility would disclose whether it is acting in accordance with the OEB guidance, and in any area where it is not, the utility would explain whether and how its approach accomplishes the same objectives as the approach set out in the OEB guidance. Overall, this would be a fairly high-

⁵⁵ See, for example, the OEB *Handbook to Electricity Distributor and Transmitter Consolidation*: “The OEB’s oversight of utility performance relies on the establishment of performance standards to be met by distributors, ongoing reporting to the OEB by distributors, and ongoing monitoring of distributor achievement against these standards by the OEB.” (p.5)

level disclosure, with limited detail required. The emphasis would be identifying whether or not the utility is following the guidance, and where different approaches are being used.

- **Recommendation 2.2: The OEB should set more detailed disclosure requirements in targeted areas of greatest significance to the achievement of its objectives. (i.e. a risk-based approach)**

Rationale: In addition to the general disclosure set out in Recommendation 2.1, more detailed disclosure is warranted in specific areas. 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 approaches, 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 a targeted risk-based approach to the monitoring (and assessment) geared to areas of greatest concern to the OEB,

given its statutory mandate and the state of utility sector. This will bring greater transparency to corporate governance practices with the greatest impact on the achievement of the OEB's objectives. A number of areas are set out below which may warrant specific disclosure. Elenchus intends to discuss these areas further with stakeholders, including how these sorts of disclosures could be made, before making final recommendations to the OEB:

- **Board responsibilities:** Disclose all Unanimous Shareholder Agreements or Sole Shareholder Declarations.
- **Director independence:** Disclose the name of each director and whether they are independent and the criteria used to determine independence. If the majority of the board is not independent, an explanation of how the board maintains independent judgment.
- **Director selection and assessment:** Disclose the necessary qualifications (the skills matrix) and selection process, including considerations of gender and diversity. Disclose orientation, education and development practices, and the directors' assessment process. Disclose the attendance record of directors (including committees).
- **Risk management:** Disclose the practices for board consideration of risk, controls, mitigation, etc., with particular attention to enterprise risk management, financial management and cybersecurity risk.
- **Stakeholder interests:** Disclose the practices for considering the interests of stakeholders in key decisions (e.g. strategy, risk, major investments, affiliate transactions, dividends, etc.). Stakeholders include customers, debtholders, shareholders, employees, suppliers, etc.

- **Conflict of interest:** Disclose the practices for identifying and addressing potential conflicts of interest in key areas (e.g. dividends, affiliate transactions, non-utility activities, etc.)
- **Board assessment:** Disclose the methods for assessment, results, and any action plan resulting from the assessment.
- **Key regulatory issues:** Disclose 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).
- **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: Require a periodic self-assessment and self-certification to supplement the disclosure and assist with assessments.**

Rationale: Disclosure on its own promotes transparency, but disclosure along with self-assessment promotes transparency and continuous improvement. It also facilitates the assessment of corporate governance practices and performance (over time and in comparison to other utilities.) This approach is consistent with securities regulator requirements for explanations of corporate governance practices and assessment against the guidance. Self-certification of adherence to the OEB guidance could be co-ordinated with a self-certification process related to provisions around compliance with legislation (introduced through Bill 112).

The self-assessment/self-certification would be signed by the chair of the board in recognition of the board's responsibility for corporate governance, and would do the following:

1. Identify where practice is in line with guidance
 2. identify where practice exceeds the guidance – and explain how
 3. Identify where practice differs from the guidance and explain approach and how it meets the objectives of the guidance
 4. identify where practice falls short of the guidance and describe the plan to address deficiency
- **Recommendation 2.4: 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: Elenchus has set out a number of recommendations above as to what information should be disclosed. However, those recommendations do not specify what form the disclosures should take. 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. There are number of approaches which could leverage existing processes. It will be important to have some forms of regular reporting to ensure that any adverse changes in the quality of corporate governance are identified promptly.

Each of the following approaches may be appropriate in certain circumstances, depending upon the specific nature of the disclosure. Elenchus intends to discuss these options with stakeholders when it is discussing the recommendations above.

- Annual filing as part of the RRR⁵⁶
- Annual scorecard which presents a subset of the full disclosure to facilitate transparency and comparative evaluation
- Utility Annual Report
- Utility website

Monitoring, while important, will not ensure that the OEB's objectives for corporate governance will be met. The OEB has indicated that it intends to develop assessment tools to further strengthen its utility corporate governance framework. Assessment is discussed in the next chapter.

⁵⁶ The OEB's *Reporting and Recordkeeping Requirements*

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 ensure the integrity of the disclosure process and 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 present our recommendations. Elenchus intends to discuss these recommendations with stakeholders in the stakeholder sessions. After those discussions, Elenchus will consider the input of stakeholders and prepare a final version of this report, along with our final 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.⁵⁷*

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

⁵⁷ KPMG, *Review of Corporate Governance of Electricity Distributors*, Final Report, April 29, 2015, p. 45.

quality of a utility's regulatory proposals will be indicators of the strength of the utility's underlying corporate governance.

In conducting assessments of corporate governance, it will be important to assess two aspects:

- Whether the corporate governance disclosure is accurate and high quality
- Whether the corporate governance practices meet the OEB guidance and/or current best practice

In assessing a 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 any deficiencies warrant regulatory action. The greatest value will come from assessing utility corporate governance on a proactive basis.⁵⁸ The OEB uses a risk-based approach for its audit and compliance activities. A similar approach could underpin its assessment activities. Elenchus' recommendations have been developed with these principles in mind.

- **Recommendation 3.1: The OEB should conduct periodic audits of the accuracy of the disclosures.**

Rationale: As with any of the OEB's reporting tools, there needs to be assurance that the reporting is being done accurately. The OEB has periodically conducted audits on the accuracy of reporting, including audits of the accuracy of the Performance Scorecard reporting and accuracy of the RRR filings. These audits could be conducted by the OEB or by an external reviewer.

⁵⁸ 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.

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

Rationale: KPMG recommended periodic assessments. The disclosure requirements recommended in the prior section provide an initial step to this work through self-assessments. The self-assessments could indicate potential areas for deeper review, thereby integrating the monitoring and assessment processes.

Assessments could take a number of forms. Each of the approaches below is designed to help the OEB assess the genuine quality of the corporate governance, beyond just the written statements included in the utility's disclosure reports. Elenchus would like to discuss these options further with stakeholders for purposes of developing our final recommendations.

- **Utility best practices:** The OEB could review the 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.

- **Focused Assessments:** The OEB could conduct focused assessments in key areas.

Rationale: The OEB could investigate the corporate governance practices

of a utility, or group of utilities, in particular areas. 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 investigations 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.

- **Utility board participation in OEB processes:** The OEB could have direct interaction with utility boards through an open process.

Rationale: The OEB cannot see directly how a utility board of directors operates. By having 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. At least three options could be considered:

- The CEO could appear as a witness in a utility's rate proceeding as the leader of the corporation.
 - The chair of the board of directors could participate in a utility's rate proceeding by being part of an initial panel which presents a utility's overall proposals. The chair could be subject to questions from the OEB panel and/or intervenors.
 - The OEB could convene a corporate governance conference, which would provide an open forum for utility directors and senior executives to exchange views and ideas with the OEB and stakeholders.
- **Recommendation 3.3: The OEB should conduct a periodic review of the OEB 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 (perhaps every 5 years) 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 of the Guidance.

DRAFT

10 NEXT STEPS

After this draft report is released, the OEB will convene a series of stakeholder sessions with Elenchus. As indicated in the OEB letter announcing this initiative, the purpose of the stakeholder sessions is to discuss the principles and recommendations set out in this report. In particular, Elenchus would like to discuss the *Preliminary Draft Guidance*, which has been prepared by Elenchus, and which appears at Appendix 1.

After the stakeholder sessions, Elenchus will prepare the final version of this report, which will include final recommendations in the form of *Draft Guidance* and final recommendations for monitoring and assessment.

APPENDIX 1: PRELIMINARY DRAFT GUIDANCE

PLEASE NOTE THAT THIS *PRELIMINARY DRAFT GUIDANCE* HAS BEEN PREPARED BY ELENCHUS FOR DISCUSSION PURPOSES AT THE STAKEHOLDER SESSIONS. IT HAS BEEN DRAFTED AS IF IT WERE AN OEB DOCUMENT, BUT IT SETS OUT ELENCHUS' RECOMMENDATIONS. 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) in discharging its regulatory mandate. This Guidance sets out the OEB's expectations regarding the corporate governance structures, policies and practices of Ontario's regulated energy utilities. The objectives of this Guidance are 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 by setting out clear expectations

This Guidance is based on Canadian securities regulation guidance and is consistent with national and international principles and best practices. The Guidance is less detailed in many areas than securities regulation guidance, and in a number of areas is focussed on the issues of greatest relevance for the OEB's regulation of utilities.

This Guidance is applicable to all rate regulated natural gas and electricity utilities in Ontario and Ontario Power Generation. While it is not mandatory for utilities to adhere to this Guidance, 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 assessment of how they have met or exceeded the principles and practices contained in this Guidance.

The Guidance is organized in the following sections:

- Responsibilities of the Board
- Directors
- Structure of the Board
- Conduct of the Board

1. Responsibilities of the Board

1.1. The board of directors should adopt a written mandate in which it acknowledges responsibility for the stewardship of the utility and sets out its responsibilities, including:

- 1.1.1. Adopting a strategic planning process and approving a strategic plan
- 1.1.2. Identifying the principal risks of the utility's business, and ensuring the implementation of appropriate systems to manage these risks
- 1.1.3. Succession planning (including selecting and evaluating the CEO)
- 1.1.4. Monitoring financial and operational performance of the utility and ensuring appropriate internal controls and information systems
- 1.1.5. Developing the utility's approach to corporate governance, including an assessment process
- 1.1.6. Adopting measures for receiving feedback from stakeholders
- 1.1.7. 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

- 1.2. The board should develop clear position descriptions for the chair of the board and the chair of each board committee.
- 1.3. The board, together with the CEO, should develop a clear position description for the CEO, which includes delineating management’s responsibilities.

Rationale: As stewards of the utility, the board of directors 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. Each of these provisions appears in National Policy 58-201, although they have been modified to remove some of the detail.

2. Directors

- 2.1. Option 1: The board should have a majority of directors who are independent of management, independent of affiliates, and independent of shareholders.

Option 2: The board should have a 2/3 majority of directors who are independent of management, independent of affiliates, and independent of shareholders.

Option 3: All directors on the board should be independent of management, independent of affiliates, and independent of shareholders.

Rationale: 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.”⁵⁹ 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.⁶⁰

Under the *Affiliate Relationships Code for Electricity Distributors and Transmitters* and the *Affiliate Relationships Code for Gas Utilities* the OEB requires that 1/3 of directors be independent.⁶¹ The *Ontario Energy Board Act, 1998* has recently been amended to reduce the limitations on the business activities of electricity distributors and introduce the potential for electricity distributors to undertake non-distribution activities (subject to OEB approval).⁶² These developments heighten the importance of independence within a strong corporate governance structure.

Elenchus concludes that a majority of directors should be independent to provide an appropriate balance between strong corporate governance and reasonable flexibility for utilities. This approach was recommended by KPMG and is also reflected in the current practice of a number of Ontario utilities, including, for example, the Fortis-owned utilities. The other two

⁵⁹ Canadian Coalition on Good Governance, *Governance Differences of Equity Controlled Corporations*, October 2011, p. 1.

⁶⁰ *Renewing Ontario’s Electricity Distribution Sector: Putting the Consumer First*, The Report of the Ontario Distribution Sector Review Panel, December 2012, p. 38.

⁶¹ *Affiliate Relationships Code for Electricity Distributors and Transmitters*, March 15, 2010, section 2.1.2 and *Affiliate Relationships Code for Gas Utilities*, November 25, 2010, section 2.1.3.

⁶² The provisions were included in Bill 112, which received Royal Assent December 3, 2015.

approaches (2/3 independent and 100% independent) have been presented as options for discussion purposes at the stakeholder sessions.

Elenchus recommends that the definition of independent be a director who has no material interest in, or relationship with, the utility's management, affiliates or shareholders. This definition goes further than the definition generally used by securities regulators, by including a reference to shareholders. Elenchus makes this recommendation because of the nature of utilities and their ownership structures (closely held) and the interest the OEB has in ensuring that decisions by a utility's board of directors are focussed clearly on the best interests of the utility and limiting areas of potential conflict of interest.

- 2.2. If the majority of the board is not independent, then a majority of independent directors should approve board decisions in the following areas: dividends, affiliate transactions, new non-regulated activities by the regulated entity, and related-party debt.

Rationale: The challenges of a closely controlled utility without a majority independent board warrant a more rigorous approach to ensure the decision-making is undertaken in a way which ensures a focus on the best interests of the utility, without undue influence by the interests of an affiliate or shareholder. This provision would adopt the principle of the OEB's decision in THESL (that a majority of the independent directors approve any dividend), and is consistent with related case law. It would reflect best practice as described by the OECD in its discussion of related-party transactions, which 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

(OECD, pp. 25-26, 52). This approach would also address issues of potential conflict of interest and provide a high level of assurance in which OEB and non-shareholder stakeholders can have confidence. This approach is analogous to the securities regulator requirement that audit committees be composed of independent directors.

- 2.3. The chair of the board should be an independent director.
- 2.4. There should be term limits for board directors to facilitate board renewal.
- 2.5. The independent directors should hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance (*in camera*).
- 2.6. Directors should be nominated on the basis of their skills and competencies, their integrity, and their commitment to the work of the board. The board should adopt a policy and/or targets relating to the identification and consideration of women as directors.
- 2.7. The board should ensure that all new directors receive a comprehensive orientation.
- 2.8. The board should provide 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 corporation 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.

Provisions 2.2 – 2.7 appear in National Policy 58-201, but have been modified to simplify the provisions.

3. Structure of the Board

- 3.1. The board should appoint the necessary committees to fulfill its responsibilities and conduct its work effectively. At a minimum, there should be an Audit Committee. Other committees could include Human Resources, Nominating, Governance, and Risk.
- 3.2. Each committee should have a written charter that establishes the committee's purpose, responsibilities, structure and operations.

Rationale: These provisions are adapted from similar provisions in the guidance of finance and securities regulators. 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 must be clear and robust to ensure shared understanding of roles and responsibilities. At a minimum each board should have an Audit Committee, given the importance financial performance to the delivery of safe and reliable energy services and the need to consider financial issues in some detail and with the benefit of suitable expertise. (Securities regulation requires that there be an Audit Committee.) However, 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. The board should consider whether there should be a stand-alone Risk Committee or whether risk should be integrated into the responsibilities of each committee with overall oversight being 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.

3.3. Audit Committee

- 3.3.1. Directors on the Audit Committee should be independent and financially literate.
- 3.3.2. The Audit Committee should be responsible for overseeing the financial reporting process, including:
 - 3.3.2.1. Overseeing the work of the external auditor
 - 3.3.2.2. Pre-approving all non-audit services to be provided by the external auditor
 - 3.3.2.3. Reviewing the utility’s financial statements and MD&A
 - 3.3.2.4. Overseeing the work of internal audit
 - 3.3.2.5. Overseeing the system of internal controls

3.4. Human Resources and Compensation

- 3.4.1. Directors on the Human Resources Committee should be independent.
- 3.4.2. The Human Resources Committee should be responsible for:

- 3.4.2.1. Reviewing and approving corporate goals, objectives and policies relevant to CEO selection and compensation
- 3.4.2.2. 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)
- 3.4.2.3. Making recommendations to the board with respect to non-CEO officer and director compensation
- 3.4.2.4. Succession planning for CEO and senior executives
- 3.4.2.5. Human resource oversight, including labour relations, ethical conduct and compensation policies

3.5. Nominating Committee

- 3.5.1. Directors on the Nominating Committee should be independent.
- 3.5.2. The Nominating Committee should be responsible for identifying and recommending new director nominees by considering:
 - 3.5.2.1. The necessary competencies and skills for the board (skills matrix)
 - 3.5.2.2. The competencies and skills of the existing directors
 - 3.5.2.3. The competencies and skills of each nominee
 - 3.5.2.4. Any policy and/or target relating to women on the board

3.6. Governance Committee

- 3.6.1. Directors on the Governance Committee should be independent.
- 3.6.2. The Governance Committee should be responsible for
 - 3.6.2.1. Recommending board policies and processes for effective and efficient governance
 - 3.6.2.2. Recommending policies for the evaluation of individual directors and the board overall
 - 3.6.2.3. Reviewing the corporate bylaws
 - 3.6.2.4. Overseeing plans for board education, including new director orientation, director education and development, and board

development

3.7. Risk Committee

- 3.7.1. Directors on the Risk Committee should be independent.
- 3.7.2. The Risk Committee should be responsible for:
 - 3.7.2.1. Developing processes and practices to identify, measure and mitigate risk, including in the areas of enterprise risk, financial management, and cybersecurity
 - 3.7.2.2. Developing recommendations for the corporation's risk tolerance policy
 - 3.7.2.3. Overseeing the processes and controls in place to manage risk
- 3.7.3. If there is no Risk Committee, then the responsibilities set out above should be discharged through the Board as a whole and through the individual committees.

4. Conduct of the Board

4.1. Code of Conduct

- 4.1.1. The board should adopt a written code of business conduct and ethics (applicable to directors, officers and employees). The code should include standards that are designed to promote integrity and to deter wrongdoing and should address the following issues:
 - 4.1.1.1. Conflicts of interest
 - 4.1.1.2. Protection and proper use of corporate assets and opportunities
 - 4.1.1.3. Confidentiality of corporate information
 - 4.1.1.4. Fair dealing with the utility's security holders, customers, suppliers, competitors and employees
 - 4.1.1.5. Compliance with laws, rules and regulations

4.1.1.6. Reporting of any illegal or unethical behaviour

4.1.2. The board should be responsible for monitoring compliance with the code.

Any waivers from the code that are granted for a director or executive officer should be 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 the utilities are providing an important public utility service and given the ownership structure of utilities in Ontario. Provision 4.1 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 in the following provisions.

4.2. Conflict of Interest: The board should develop 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 corporation as a whole, taking into account the interests of all stakeholders.

- 4.3. **Risk:** The board should develop processes and practices to effectively identify, measure, and mitigate risk. The board should explicitly identify the corporation’s risk tolerance and oversee the processes and controls in place to manage risk. If there is no Risk Committee, then these responsibilities should be discharged through the Board as a whole and through the individual committees.
- 4.4. **Strategy:** The board should develop processes to ensure the development of a strong corporate strategic plan. The board should explicitly approve the corporation’s strategy, and the board should oversee the implementation of the plan, the alignment with regulatory proposals, and the assessment of corporate performance against the plan.
- 4.5. **Stakeholder Interests:** The board should develop processes and practices that promote effective consideration of stakeholder interests as part of the board’s decision-making. This would include the consideration of the impacts of rate proposals on customers.
- 4.6. **Communication:** The board should develop processes and practices that promote effective and appropriate communication, including:
- 4.6.1. information sharing between the board and management
 - 4.6.2. information sharing between the board and the shareholders
 - 4.6.3. disclosure of corporate governance practices

Rationale: Provisions 4.3 – 4.6 reflect areas of specific relevance to OEB regulation and have been adapted from the provisions in National Policy 58-20. They also reflect current best practice (see, for example, CCCG’s *Building High Performance Boards* and *2015 Best Practices* and the G20/OECD’s *Principles of Corporate Governance*).

4.7. Assessment

4.7.1. The board and its committees should be regularly assessed regarding their effectiveness.

4.7.2. Each director should be regularly assessed regarding his/her effectiveness.

Rationale: Provision 4.7 is similar to the provisions of National Policy 58-201, although it has been simplified. Assessment is a key step in continuous improvement, and widely recognized as best practice.

DRAFT

APPENDIX 2: SUMMARY OF ELENCHUS RECOMMENDATIONS

Guidance

- **Recommendation 1.1:** The OEB guidance should be based on financial and securities regulator guidance.
- **Recommendation 1.2:** The OEB guidance should be consistent with the principles in G20/OECD 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*.
- **Recommendation 1.3:** The OEB guidance should address the following areas:
 - **Responsibilities:** The board of directors is responsible for setting the corporation's strategy, overseeing the risk of the corporation, monitoring the financial and operational performance of the corporation, and selecting and evaluating the CEO. These core responsibilities must be undertaken by skilled directors, based on a robust structure and with conduct of the highest integrity.
 - **Directors:** 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 corporation. They must be able to challenge management while working cooperatively in the best long-term interests of the corporation.
 - **Structure:** The roles and responsibilities of the board, the committees and the individual directors must be clear and robust.
 - **Conduct:** The individual directors (and the board as a whole) must conduct themselves with the highest integrity, using the appropriate tools

to govern communications, conflicts and relationships and to set, evaluate and improve individual and overall performance.

- **Recommendation 1.4: The OEB guidance should include more detailed provisions in specific areas of greatest concern to the OEB.**

Monitoring

- **Recommendation 2.1: Implement disclosure requirements aligned with the OEB guidance.**
- **Recommendation 2.2: The OEB should set more detailed disclosure requirements in targeted areas of greatest significance to the achievement of its objectives. (i.e. a risk-based approach).** A number of areas are set out below which may warrant specific disclosure. Elenchus intends to discuss these areas further with stakeholders:
 - **Board responsibilities:** Disclose all Unanimous Shareholder Agreements or Sole Shareholder Declarations.
 - **Director independence:** Disclose the name of each director and whether they are independent and the criteria used to determine independence. If the majority of the board is not independent, an explanation of how the board maintains independent judgment.
 - **Director selection and assessment:** Disclose the necessary qualifications (the skills matrix) and selection process, including considerations of gender and diversity. Disclose orientation, education and development practices, and the directors' assessment process. Disclose the attendance record of directors (including committees).
 - **Risk management:** Disclose the practices for board consideration of risk, controls, mitigation, etc., with particular attention to enterprise risk management, financial management and cybersecurity risk.

- **Stakeholder interests:** Disclose the practices for considering the interests of stakeholders in key decisions (e.g. strategy, risk, major investments, affiliate transactions, dividends, etc.). Stakeholders include customers, debtholders, shareholders, employees, suppliers, etc.
- **Conflict of interest:** Disclose the practices for identifying and addressing potential conflicts of interest in key areas (e.g. dividends, affiliate transactions, non-utility activities, etc.)
- **Board assessment:** Disclose the methods for assessment, results, and any action plan resulting from the assessment.
- **Key regulatory issues:** Disclose 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).
- **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: Require a periodic self-assessment and self-certification to supplement the disclosure and assist with assessments.**
- **Recommendation 2.4: 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.** Elenchus intends to discuss these options with stakeholders when it is discussing the recommendations above.
 - Annual filing as part of the RRR⁶³
 - Annual scorecard which presents a subset of the full disclosure to facilitate transparency and comparative evaluation
 - Utility Annual Report
 - Utility website

⁶³ The OEB's *Reporting and Recordkeeping Requirements*

Assessment

- **Recommendation 3.1: The OEB should conduct periodic audits of the accuracy of the disclosures.**
- **Recommendation 3.2: The OEB should conduct periodic assessments of governance practices against best practice and the OEB guidance.** Elenchus would like to discuss the following options further with stakeholders for purposes of developing our final recommendations.
 - **Utility best practices:** The OEB could review the disclosure information and identify best practices and high quality disclosure which could serve as benchmarks for others.
 - **Focused Assessments:** The OEB could conduct focused assessments in key areas.
 - **Utility board participation in OEB processes:** The OEB could have direct interaction with utility boards through an open process. At least three options could be considered:
 - The CEO could appear as a witness in a utility's rate proceeding as the leader of the corporation.
 - The chair of the board of directors could participate in a utility's rate proceeding by being part of an initial panel which presents a utility's overall proposals. The chair could be subject to questions from the OEB panel and/or intervenors.
 - The OEB could convene a corporate governance conference, which would provide an open forum for utility directors and senior executives to exchange views and ideas with the OEB and stakeholders.
- **Recommendation 3.3: The OEB should conduct a periodic review of the OEB 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.**

APPENDIX 3: 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 4: OEB CORPORATE GOVERNANCE FILING

REQUIREMENTS

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 5: 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.ccg.ca/>
 - 1) *2015 Best Practices*:
http://www.ccg.ca/site/ccgg/assets/pdf/2015_best_practices.pdf
 - 2) *Building High Performance Boards*:
http://www.ccg.ca/site/ccgg/assets/pdf/building_high_performance_boards_aug_ust_2013_v12_formatted_sept.19,2013_last_update.pdf
 - 3) *Governance Differences of Equity Controlled Corporations*:
http://www.ccg.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](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
- *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