
Forum

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An Assessment of: 'A Framework for Competition – The Report of the Advisory Committee on Competition in Ontario's Electricity System to the Ontario Minister of Environment and Energy, May 1996'

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Anyone taking a critical view of this *Report* and its recommendations must do so with some trepidation because the Ontario Government has appointed the ultimate in blue ribbon panels. I recall joining the federal Department of Energy, Mines and Resources in the late 1970s and asking a senior public servant who had been the best Minister during his 25 years in the Department. Without hesitation, he answered "Donald Macdonald" (who served as Chair of the Advisory Committee).

Over the years, the other members of the Advisory Committee have also helped shape the public policy agenda, either as direct participants in the policy-making process or as expert analysts and commentators. Thus, by the time Darcy McKeough became involved in corporate restructuring and privatization issues in the mid-1980s as head of the CDIC (Canada Development Investment Corporation), he had already had an illustrious career which included being Treasurer of Ontario. Professor Leonard Waverman has, of course, been one of Canada's prominent authorities on regulated industries, especially in the energy sector since the early 1970s, while John Grant was for many years a leading Bay Street economist. Jon Carr, Robert Gillespie

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and Sylvia Sutherland may be less well known, but their backgrounds complement the experience of the other members extremely well. And yet despite the outstanding reputation of its authors, this *Report* on the future of the electric power industry in Ontario is on occasion irritating and, at the end, unsatisfying. For some reason, the authors have chosen to use the phrase "we believe" liberally throughout the text. After the fiftieth "we believe" (it is used four times on page 39 alone), the reader should be forgiven for thinking, "It's nice that you have religion, but where is the empirical evidence?" Alternatively, the reader might come to the conclusion that the *Report* is all about another leap of faith.

This particular concern regarding the empirical evidence could have been addressed relatively easily. Thus, the central conclusion of the *Report* is that the introduction of competition, especially at the generation phase of the electricity industry will, under conservative assumptions, lead to an 11% decline at least in wholesale electricity prices by the year 2005 over the status quo, that is an unregulated monopoly (Ontario Hydro). As the *Report* notes, these results depend on the assumptions behind the simulations of the various scenarios, but why not spell out the key assumptions and present the sources of the reductions in wholesale electricity costs (overhead costs, fuel costs, capital costs, labour costs, etc.)? It is not really acceptable to suggest that the explanations and evidence are found in an appendix or a background study because these are not readily accessible to everyone. Based on a reading of the *Report* alone, one can only come to the conclusion with respect to the claim of lower electricity costs that a Scottish verdict is justified, that is, not proven.

Indeed, a reader who looks at the graph on page 21 may well conclude that the *Report's* recommendations represent a solution in search of a problem. Thus, industrial power rates in Ontario are shown to be below those found in a sample of US jurisdictions. The authors express the concern that US power companies nevertheless may offer very attractive rates to particular industrial users with a detrimental impact on the competitiveness of their Ontario-based rivals. This is a real worry, but Ontario Hydro would appear to have some scope (if not enough legal flexibility) to take counter measures. However, any attractive offer by Ontario Hydro would fly against the *Report's* objections to cross subsidization. Thus, the *Report* raises some legitimate issues, but it is never quite clear how increased competition and the infusion of private equity will deal with the problems. In those US jurisdictions and for those US industries (e.g., pulp and paper) where industrial power rates are especially attractive, it is the regulatory framework, and not competition or private equity, which appears to be the key ingredient in providing low-cost electricity.

The *Report* may well be correct in suggesting that the status quo will simply prove to be untenable, but it does not provide a

The Report's recommendations include the creation of at least three new regulatory bodies.

description of the future under which Ontario Hydro, as currently structured, will go the way of the dinosaur. One possibility is that technological change and international agreements will bring about a completely integrated North American electricity market. Under these circumstances, Ontario Hydro would have to compete with all the other power companies – it would have no choice. One justification for the proposals of the *Report* could be that it is preparing Ontario Hydro for this kind of future. However, this idea of minimizing transition costs to a fully integrated electricity market is never really explored. The example of natural gas is duly noted, but then differences with electricity are alluded to without ever fully explaining them and their implications. In summary, the *Report* questions the viability of the status quo without providing a clear basis for the scepticism.

One should also note that the *Report* appears to suggest that the North American trend toward deregulation will have implications for Ontario Hydro and its ability to compete. However, deregulation is not the correct word to use in the Ontario context because Hydro is an unregulated utility – admittedly with some regulatory functions. Ironically, the *Report* would create more regulation and more bureaucracy than currently exists. Thus, were the *Report's* recommendations to be implemented, there would result at least three regulatory regimes – one each for generation, transmission, and distribution; and also two new institutions, namely, a Systems Operator and an Electricity Exchange. The net costs of this regime are not spelled out in the *Report*, presumably because they have been found to be negative. Again, where is the evidence?

As various commentators have noted, the key recommendations of the *Report* focus on increasing competition in the generation and distribution (but not, for obvious reasons, the transmission) of electricity. Even if one accepts this proposition (and there are good reasons to accept it), there is still the question of whether the *Report's* recommendations provide the basis for meaningful competition. Thus nuclear power, which currently provides 60% of the generating capacity, is expected to remain in public hands, but split into four operating companies. The hydro facilities at Niagara Falls are also slated to stay under public ownership and operated as one entity, which implies that approximately 70% of the province's electricity generating capacity will not really be part of the competitive sector. As well, the *Report* does not clearly spell out if and how vertical and horizontal mergers and acquisitions in the privately-owned sector will be prevented.

The UK model provides some useful lessons in terms of introducing and then ensuring the continuance of competition in the electricity sector. Some have argued that the fault in the UK system is the existence of only three major power generators: Power Gen, National Grid, and British Energy (the sector's nuclear component, which is currently being privatized). As observers of

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the UK scene have noted, the real competition comes from independent power producers and imported electricity. There is no reason to expect the Ontario situation to be any different, and this would be especially true once the electricity grid in North-eastern North America became completely integrated. With regard to independent power producers, it is self evident, whether in the UK or Canada, that the low capital costs and cheap fuel costs of natural gas driven turbines provide a basis for competing against alternative sources of power. Therefore, under current conditions, the source of the competitive pressure does not come from many competing electricity generators, but from the continuance of the gas bubble and the multitude of natural gas producers. From this perspective, it is unlikely that, over time, the implementation of the *Report's* recommendations would lead to a more competitive structure.

One wonders whether the Committee members in trying to reach a consensus did not finally settle on the call for competition as something of a godsend. Certainly, anyone familiar with this area of public policy would know that the public response to a survey question reading: "Do you favour increased competition in Ontario's electricity industry?" – would probably be overwhelmingly positive, while the same could not be said for the response to: "Do you favour the privatization of Ontario Hydro?" As suggested above, however, the problem is that the implications of the latter question are reasonably clear and one could also deliver on it, while this is not quite the same for the former question – at least not given current infrastructure, technology and policies.

The *Report* emphasizes that the "status quo is not good enough", and the Minister of Environment and Energy has echoed these remarks. However, one must ask what this phrase means in specific terms. Presumably, it means that lower costs and prices and/or improved service reliability can be achieved by changes to the status quo. The issue of costs and prices has already been discussed, but on service reliability the *Report* is almost completely silent. This is equivalent to someone assessing the comparative merits of North American, European and Japanese automobiles without ever mentioning the *J.D. Power Rankings*, the *Consumer Reports* evaluations or the findings of *Lemon Aid*. My local utility claims a reliability rating of 99.9%. I am not sure what this means, but one would have expected that the *Report* would make a case for an improvement in some such measure if its recommendations were to be implemented.

Perhaps, this oversight in the *Report* is due to the failure to discuss in explicit terms the governance issue. Implicitly, one might speculate that, at least for the privatized parts of Ontario Hydro, the *Report* is recommending shareholder companies, but one cannot be sure because the recommended regulatory regime is presumably there to reflect the interests of other stakeholders. Whatever the faults of the current institutional structure, it is

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reasonably clear that Ontario Hydro and the municipal electric commissions are stakeholder companies who have historically tried to balance the interests of various classes of consumers (industrial, commercial, residential), employees, and governments (as shareholders and promoters of economic development). One can certainly argue that the stakeholder model of governance for a utility is passé and should be replaced by a shareholder model (with a focus on yielding an adequate rate of return for the private owners). Alternatively, one can argue that the stakeholder model has given short shrift to the consumers (and taxpayers) and that their interests should be better reflected in any future structure for the electric power industry. However, the *Report* does not face this issue head on. In direct contrast, one of Margaret Thatcher's closest advisors on privatization has argued that shareholder accountability is largely a myth, and that accountability to the customer is the real driver behind corporate decisions – at least for successful corporations.

The bottom line question is where does one want to end up on the governance issue for each stage of the electric power industry (generation, transmission, distribution) and each component (public, private, nuclear, fossil). It can certainly be argued that the *Report's* recommended regulatory scheme will take care of the governance issue. However, one wonders whether local consumers who currently have the option to complain and ultimately replace the Hydro-Electric Commission members will take such a sanguine view of the proposed changes.

With regard to the recommendations on privatization, one can only say that the *Report* attempts to please everyone, and in doing so may end up pleasing no one. In those areas where privatization appears to be difficult – such as nuclear generators (liability and environmental issues) and the Niagara Falls stations (emotional attachment) – it is set aside, but in areas where it appears to be easy (fossil fuels, smaller hydro) privatization is recommended. This approach is bound to raise all sorts of controversy related to cherry-picking and accusations of privatization by step and by stealth. As well, a situation of mixed ownership is likely to make the issue of the level playing field between Ontario Hydro and private generators even more controversial than it is now.

If there are important policy issues, as there appear to be, with regard to the privatization of what is currently 70% of the generating capacity, then those issues should be dealt with up front. Recent examples (British Nuclear, Eldorado Nuclear, among others) suggest that state-owned enterprises in the always-sensitive nuclear area can be privatized. However, these examples also indicate that there are policy choices to be made, and that these should be identified and dealt with early in the privatization process.

The suggestion of privatization raises the obvious issue of who currently owns Ontario Hydro and the local distribution

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companies. There is nothing wrong with having this matter legally clarified as the *Report* suggests, but with regard to principle, it is clear that the public at large believes it owns Ontario Hydro and that local communities own the distribution networks. The *Report* takes a rather defensive tone on the ownership of the local utilities. There would have been no need to be defensive if the ideas which were voiced in some quarters and which amounted to expropriation without compensation had been stopped in their tracks. Notwithstanding the desirability of appropriate capital structures and debt-equity ratios, it will come as some relief to those who already don't know it that there is at least one institution (the local hydro utility) which is not loaded up with debt. Any change in the situation should be pursued with caution.

The *Report* and its recommendations leave the Ontario Government in something of a quandary. On the one hand, the *Report* does not provide a basis for concluding that, on the whole, the current system of supplying consumers with electricity has served the province well. It spends far too little time on benchmarking the performance of Ontario Hydro and on the changes that have occurred in the last few years in order to come up with this conclusion. As well, it deals with some of the stakeholders, such as employees and environmentalists, in a rather brief and cavalier fashion. In addition, it spends even less time on the historical development of public power in Ontario, and how the province ended up with the system that it has. (Perhaps one should not be too critical of the *Report* on this account, because I had to ask my local library to get William Rothwell Plewman's 1947 book on Sir Adam Beck and the Ontario Hydro out of storage.) Therefore, the *Report* does not permit the current Ontario Government to say the system has served us well and that, as Progressive Conservatives, we believe in preserving what is good from the past, and moreover, public power was a "conservative" idea in the first place.

On the other hand, the *Report* also does not provide the basis for a privately-owned and highly efficient electric power industry, which would be a leader in an integrated North American electricity grid. It proposes far too many regulatory shackles for that, and makes far too weak a case for privatization.

Under these circumstances what should the Government do? Briefly, it should select those recommendations that make some sense, and can be readily implemented (e.g., the boundaries adjustments of the municipal utilities) and proceed with them. It should also examine whether the policy issues that would permit a bolder approach to privatization and competition can be resolved. As well, it should assess whether the regulatory framework as proposed in the *Report* can't be simplified and made less cumbersome. These are some obvious roles either for the Government and the Ministry of Environment and Energy, or for the task force proposed by the *Report*.