

On the Brink: Avoiding a Canadian California

Ontario's government has imposed substantial burdens on customers, with no benefits.

BY A.J. GOULDING

On a recent trip through Toronto's Pearson International Airport, I was stopped by an immigration official who, upon learning my business, snapped, "Why would anyone hire a Yank to advise on the Ontario electricity sector?"

Based on the recent passage of Bill 210, which freezes prices to end-users, Ontario Premier Ernie Eves seems to be taking advice from California Gov. Gray Davis. In the face of electricity price volatility far less extreme than observed in California, Ontario's provincial government has imposed measures that, over the long run, will put substantial additional burdens on consumers, with no corresponding benefits. In effect, the provincial government has chosen to destroy the village in an attempt to save it, when the village was never in danger in the first place.

It is easy to identify flaws in the law that caps retail prices through 2006, and the government's directive to Ontario Power Generation (OPG) to "assess" a suite of projects with doubtful economics given current market supply/demand dynamics.

First, the price caps, which are set below the all-in cost of new entry, will actually serve to decrease supply additions, leading to higher prices later. Note that while the cap does not apply to the wholesale market itself, it affects

the liquidity of market participants and thus affects both the motivation and the ability to hedge in the wholesale market. The caps are completely unsustainable: Until wholesale prices fall in response to the recovery of laid-up nuclear plants, maintaining the price caps may entail massive subsidies from taxpayers to ratepayers.

Second, the caps respond to a problem that is more a question of timing than of magnitude. The government panicked after reviewing only six months of data since the May 1 Ontario market opening, and before reaching months in which wholesale prices could be expected to decline. Indeed, our modeling shows that Ontario prices will fall in coming years if the nuclear facilities are restarted.

Ontario prices are not anomalous relative to neighboring regions; with an ounce of creativity a rebate could have been designed that mollified consumers without gutting the marketplace. Furthermore, retroactive rebates have no impact on past consumer behavior whatsoever, except to make those who prudently entered into long-term contracts look foolish. Customers are unlikely to enter into such contracts in the future if they know that the government will bail them out later. Their unwillingness to enter into contracts makes it more difficult for new entrants to find buyers for the output of new projects and to obtain the financing required to start construction.

Third, placing responsibility for increasing supply in the hands of OPG and directing it to assess or proceed with specific projects means that Ontario's electricity future will be determined without reference to the discipline of the market. Were OPG a private firm, it would be under intense scrutiny for its timing and expenditure related to the restart of the Pickering A nuclear units.

Leaving aside OPG's record on bringing projects in on time and under budget, the point of opening the market to competition is to shift the risks of building new capacity to private

ONTARIO POWER MARKET MILESTONES

- Oct. 30, 1998: Bill 35 passed restructuring Ontario electricity sector
- April 1, 1999: Ontario Power Generation (OPG) and Hydro One created out of former Ontario Hydro
- Nov. 7, 2000: Municipal electric utilities corporatized and converted to for-profit entities
- May 1, 2002: Independent Market Operator commenced competitive wholesale market operations
- Dec. 9, 2002: Bill 210 receives royal assent; freezes generation component of retail rates at Cdn. 4.3 cents per kWh through 2006
- Four years after market opening: OPG to reduce share of "price setting capacity" to 35 percent
- Ten years after market opening: OPG to reduce total generation market share to below 35 percent

investors, who, because they bear the losses if a project fails, scrutinize it more carefully to make sure it is economically sound. The Ontario market does not need more high-cost projects controlled by its dominant generating company. Instead, it needs certainty about when or whether laid up nuclear facilities will be brought back to service (essential from the standpoint of private developers' project planning), a vibrant bilateral contracts market, and the division of OPG into as many as five distinct generating companies.

The tragedy of the government's actions is that they decimate the promising foundation already in place for a competitive wholesale power market in the province. The Ontario Independent Market Operator (IMO) is a highly professional organization that has worked hard to ensure a transparent and functioning market. Two significant private sector players have made substantial commitments to the Ontario generation market in leasing or buying former OPG assets. Municipal utilities were corporatized, and were gradually consolidating. Performance-based ratemaking (PBR) would have resulted in efficiencies in the wires business, likely reducing customer bills. By freezing wires charges in addition to the price cap, the government has made PBR much more difficult to implement. On the retail side, Ontario had experienced high levels of customer switching, and exposure to market prices provided appropriate signals to consumers to adjust consumption.

If the government were genuinely interested in sustainable low-cost electricity for Ontario residents, it would break OPG into several generating companies, which even under continued government ownership could be structured to more effectively encourage competition. It would associate the Pickering restart with stringent

ONTARIO'S ELECTRICITY PRICING, CONSERVATION AND SUPPLY ACT (BILL 210)

Price freezes and rebates

- Cap generation component of customer bills at Cdn. 4.3 cents/kWh through 2006
- Refund amount above 4.3 cents/kWh paid by consumers since May 1, 2002
- Cap uplift charges at current level
- Pay Cdn. \$75 to consumers by year-end 2002
- Freeze wires charges and return municipal utilities to non-profit status unless municipality declares them to be for-profit (most are expected to elect for-profit status)

Tax incentives

- New alternative or renewable projects temporarily exempt from municipal and school taxes
- Accelerated write-off of capital costs associated with generation from alternative or renewable resources
- Sales tax rebate on energy-efficient appliances

Government also directed OPG to accelerate consideration of several projects at the Beck hydro station and the Hearn CCGT.

penalties for missed deadlines, possibly increasing the extent of private sector involvement. If it must intervene, it would also request the IMO to study short- and long-term capacity needs, and if a shortfall was identified, work through the IMO to develop limited and targeted incentives for the appropriate amount of new capacity.

It is extremely difficult to unscramble an egg. The government has recklessly raised consumer expectations, and almost certainly provided for increased pain to consumers in the coming years. Even the most careful crafting of regulations to implement

Bill 210 will not be able to mitigate the severe disruption caused by the legislation. Ontario needs to replace the bill with a sound foundation for the power sector that accomplishes the transition to a competitive wholesale market with political concerns regarding price stability.

There are a number of steps the government can take to restore confidence in the Ontario power sector. One approach considered during the Ontario market design process, and due for a resurrection, would be to link the creation of multiple generation companies with the establishment of a retail endowment, essentially a series of vesting contracts that would phase out over a period of five years. These companies could later be partially or fully privatized, through public offerings or the sale of strategic stakes. The government should divide OPG into five legally separate generation companies, being sure to mix peaking and baseload capacity in each. The companies would be profit-maximizing and have independent boards and completely separate trading operations.

Each genco would have a contract for differences (CfD) with the Ontario Electricity Financial Corp. (OEF, the entity charged with dealing with Ontario's stranded debt), in which the strike price would be designed to provide a commercial rate of return based on the fuel and technology mix of the individual genco and calculated using current forward prices for the relevant fuels. Initially, the CfDs would cover the entire volume of each genco at a specific projected load factor; each year, one-fifth of the original total would be released from the CfDs. When the CfDs are out-of-the-money, OEF would make payments to gencos, recovered through the stranded assets charge. When the contracts are in-the-money, customers would receive credits on their

Steps To Restore Confidence in the Ontario Market

- Complete sale of HydroOne
- Split OPG into five legally separate generation companies, with independent boards and trading staffs, and operating according to commercial principles
- Commit to privatization schedule for the “baby-OPGs,” potentially utilizing partial privatization methods or IPOs to maximize value
- Create contracts for differences (CfD) with OEFC with each of the baby-OPGs, initially for the entire volume of each, and then reducing by one-fifth every year
- Reduce stranded debt with proceeds from sales of baby-OPGs
- Fund payments from OEFC by stranded debt charge when CfDs are out of the money; when CfDs are in the money, customers receive a credit
- Purchase power from competitive retailers or via default service for customers
- Eliminate freeze on wires charges
- Proceed with implementation of second generation PBR for wires companies

bills. The CfDs would replace the MPMA, which would be terminated. Strike prices for the CfDs would likely be below recent historical Ontario prices; while wholesale prices would deviate from CfD levels due to the costs of imports and of in-province generation resources not covered by the CfDs, credits from the CfDs would cushion the blow of price spikes to final consumers.

Customers would continue to purchase power through competitive retailers or under default supply obligations. However, establishing contracts for differences could simultaneously add stability to end-user bills while increasing the stability of earnings of the gencos, ultimately making them

easier to sell. Proceeds from sales would be used to help reduce stranded costs.

In the meantime, the government also needs to proceed with the partial sale of Hydro One, the provincially owned transmission and distribution network, and to continue with the process of putting in place the second generation of performance-based ratemaking for Ontario wires companies. Even prior to the promulgation of Bill 210, the delay and constant changes in direction regarding the Hydro One sale and the sale of OPG assets such as Antikokan and Thunder Bay were making investors leery of the Ontario market. A credible timetable for creating gencos, smoothing the

transition to competition through use of vesting contracts, and continuing with the sale of Hydro One will both improve investor confidence and help to provide sustainable, competitively priced electricity to Ontario, helping to undo the harm caused by the provincial government to date.

Getting power sector deregulation right does not require the advice of Yanks. It does, however, require patience and persistence. Following the next provincial election, the Ontario government should think carefully about how to replace Bill 210. This entails designing price stability mechanisms for small consumers that do less damage to market dynamics; promoting competition by breaking up OPG; and credibly resolving the timing of the Pickering A restart. Otherwise, the short-term pain endured by Ontario electricity consumers to date will be dwarfed by the long-term cost of the provincial government's poorly conceived market intervention. ■

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