

Let's Get This Party Started

Why Ontario needs a competitive market.

By A.J. GOULDING



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For the past two years, the Ontario power sector has resembled a piñata at a children's birthday party, batted this way and that by the stick of public policy. Since the competitive wholesale market opened in 2002, the government twice has intervened to manage prices to final consumers. The first attempt (Bill 210), less than nine months after market opening, capped selected end-user prices at a rate below the wholesale cost of power and acceler-

ated the build-up of stranded debt. The second, under a new government, adjusted pricing mechanisms to better reflect wholesale costs and provide moderate incentives for conservation. The next blow at the piñata is expected this summer, in the guise of new legislation intended to establish a new framework for the Ontario power sector.

Prior to Bill 210, the wholesale market appeared to be operating reasonably well. Prices were not dissimilar with those found in neighboring regions, fluctuating consistent with changes in plant availability, fuel prices, demand,

and demand forecast errors.

Although customers had seen bills increase during the summer of 2002, this was due to a confluence of events: (1) Municipal utilities were in the process of being corporatized, meaning distribution rates were increasing; (2) rates prior to market opening had been held artificially low; (3) a hot summer led to increased consumption, which resulted in higher bills due to higher volumes (rather than higher prices); and (4) delayed restart of base-load capacity meant fewer low-cost resources were available. Despite the fact that many of these events would have led to increased bills under the former structure as well, customers blamed wholesale market opening.

It is fashionable to claim that the Ontario power sector is in crisis, and to label it a case of market failure. But the "crisis" arose because Ontario never allowed the market to operate effectively in the first place, as a brief »



Illustration by Alex Stephen

historical review will demonstrate.

Formerly, Ontario Hydro (OH) served as a self-regulating, vertically integrated monopoly that supplied end users either directly or through nearly 300 municipal utilities. An aggressive building program in the 1970s had, by the 1990s, resulted in over-capacity and massive debt. Although OH generally had been able to fend off or co-opt calls for reform, poor performance in its massive nuclear fleet ultimately contributed to a decline in public confidence, leading to a full restructuring of the Ontario power industry. This restructuring resulted in OH being broken into several surviving companies. Chief among them were Ontario Power Generation (OPG) and Hydro One.

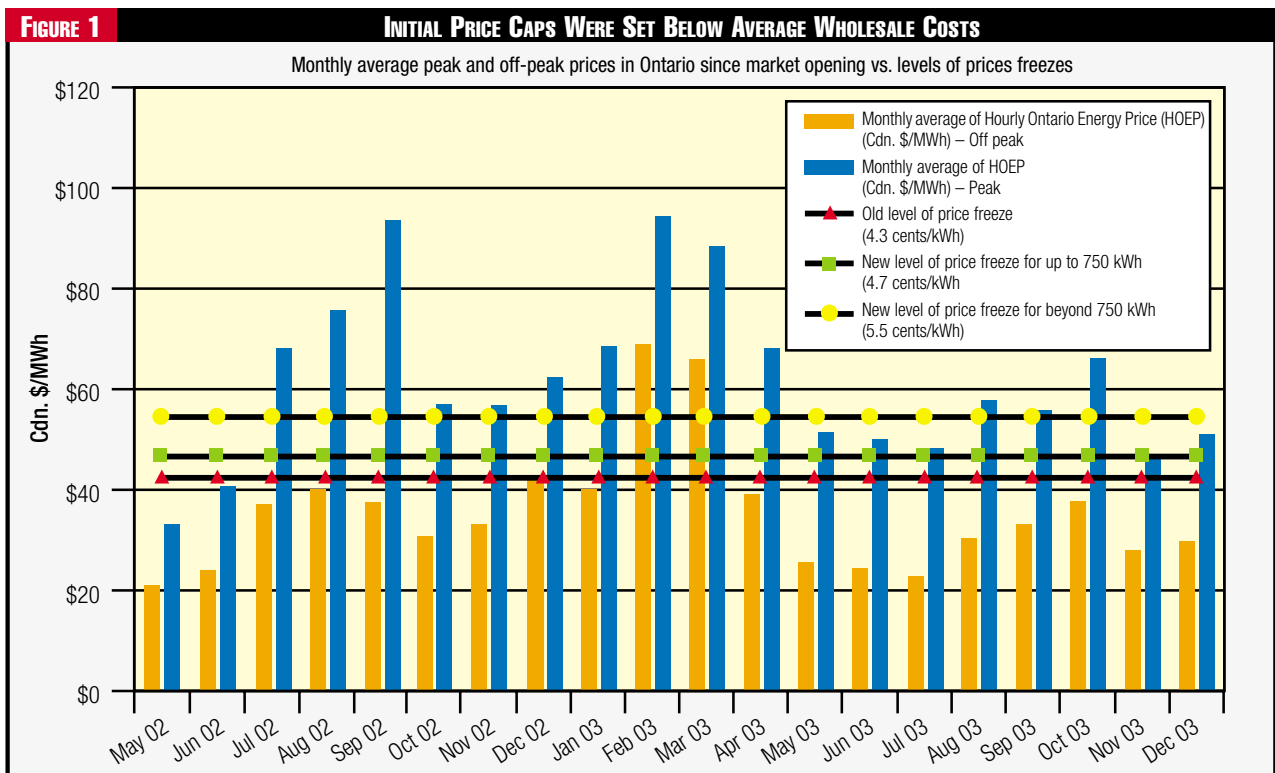
At the time of market opening, OPG controlled approximately 80 percent of operable capacity in the province. For investors considering building new capacity in the province, this posed two challenges: First, future wholesale market prices would clearly

be influenced by OPG's bidding behavior; and second, as a provincially-owned generator, OPG was likely to have different incentives than would a private-sector entity. Under provincial control, market participants could legitimately wonder whether OPG would, at times, be under political pressure to hold prices below short-run equilibrium levels.¹

OPG's bidding behavior was not the only issue troubling potential developers. Equally problematic was the fate of OPG's mothballed nuclear stations. The shutdown of seven of OH's nuclear facilities (an eighth had been mothballed earlier) in 1997 transformed Ontario from a major power exporter to an occasional power importer. Prior to the shutdown, Ontario had substantial excess capacity. Developers needed to grapple with whether, and when, the nuclear facilities would be restarted, as a full restart would delay need for new capacity by several years. Indeed, announced plans by OPG and Bruce

Power (an entity formed to lease one of OPG's three nuclear generating complexes) called for restarting six of the eight mothballed units. Bruce Power successfully restarted two of the four units under its control (it originally had no plans to restart the other two units). To date, OPG has managed only to activate one of the four units it planned to bring back to service, massively over budget and behind schedule.

Thus, at market opening, developers could reasonably have believed that approximately 2,100 MW of base-load capacity would be brought back on line over a relatively short time period. Under such circumstances, to say that the market has "failed" due to the fact that substantial new capacity additions have not been built is absurd. Delaying investment was completely rational on the part of the private sector; indeed, a centrally planned electricity monopoly that expected to restart mothballed nuclear reactors would have behaved in exactly the same way. Given that



capacity addition decisions have been rational, and prices have not been anomalous, why are some policy-makers in Ontario so keen to turn their backs on the market?

The recent change of government in Ontario has further complicated electricity policy in the province. The Liberal government has committed itself publicly to shutting down all coal-fired capacity in the province, potentially as early as 2007. More than 6,000 MW of OPG capacity, or approximately 20 percent of Ontario operable capacity, is coal-fired. While it is debatable whether shutting down coal-fired power stations is the least-cost way to achieve a desired level of improvement in Ontario environmental conditions, doing so undoubtedly will increase the cost of electricity. Completing the phase-out by 2007 would be, at a minimum, financially onerous and may pose technical challenges; more likely, the process will take place over a period of at least five years. Regardless, retirement of the coal stations makes development of new capacity an imperative. Again, however, developers face a conundrum: How can they be sure that, if they build new capacity to replace the coal stations, the government will follow through on its commitment to shut down the coal plants?

Current plans call for the Ontario government to issue a Request for Proposals for more than 2,000 MW of new capacity. Crucial questions, such as who the counterparty will be and how the counterparty will convey the power to end users, have yet to be asked. In the meantime, a committee established to review the operations of OPG and suggest potential changes has made its recommendations. Its findings would essentially leave OPG unchanged, except for subjecting its rates to cost-plus-rate-of-return regulation by the Ontario Energy Board (OEB).

FIGURE 2 ONTARIO PRICES HAVE NOT BEEN ANOMALOUS RELATIVE TO OTHER MARKETS

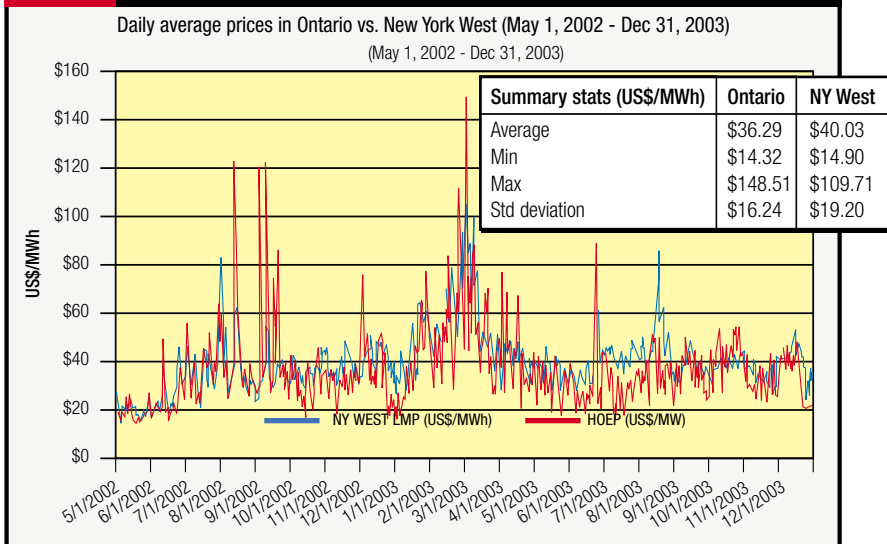
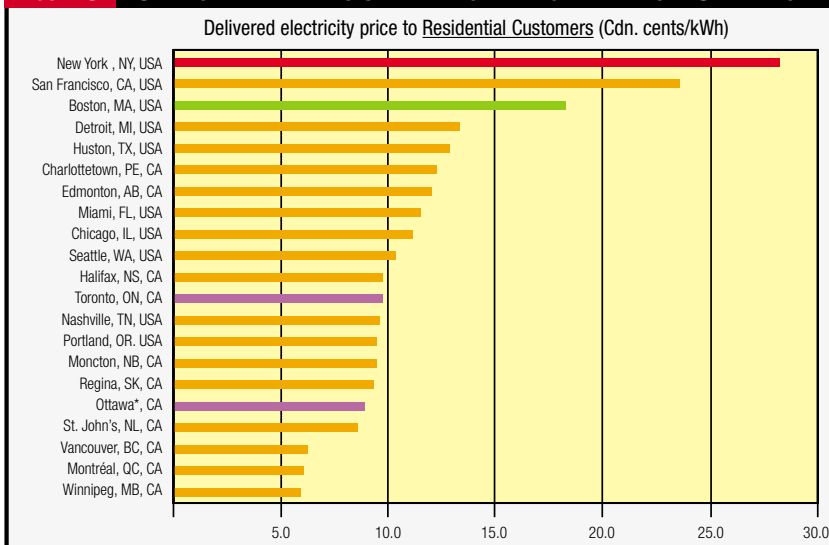


FIGURE 3 ONTARIO DELIVERED PRICES REMAIN LOW BY NORTH AMERICAN STANDARDS



* Under Federal jurisdiction

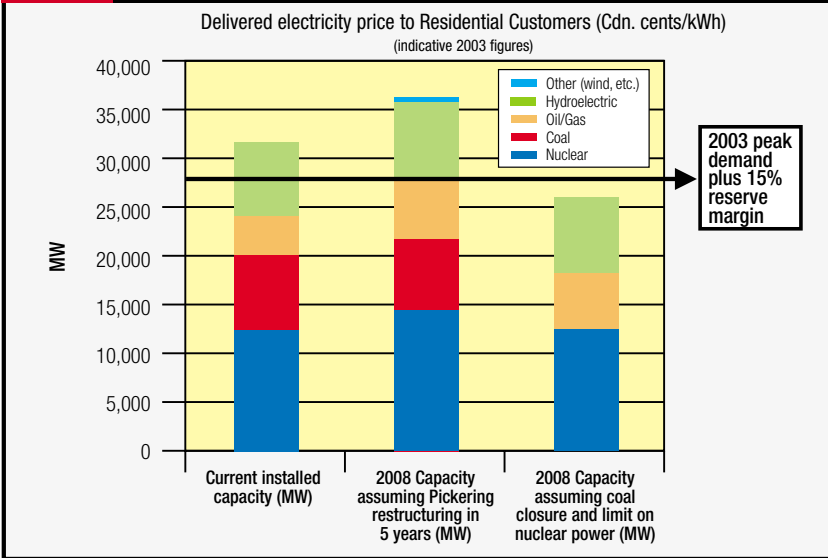
Curiously, after noting that OPG and its predecessor have a history of being subjected to political interference, the review committee made no substantive suggestions on how such interference can be prevented if OPG continues to be owned 100 percent by the provincial government. The recommendations specifically leave open the possibility for OPG to construct new capacity in the province. Given the potential for a provincially owned OPG to inappropriately apply a cost of capital substantially lower than private-sector

actors when considering new projects, this proposal could have a chilling effect on planned private-sector investment.

Ontario appears to be headed toward a market structure in which OPG continues its dominance and procurement ultimately resembles a single-buyer model, with heavy reliance on long-term purchase power agreements. Since such an approach is likely to deaden incentives for efficiency, both in operations and in capital allocation, it is worthwhile to consider some alternatives.

FIGURE 4

CUTTING COAL-FIRED POWER WILL CAUSE CAPACITY SHORTAGES



We believe that the following steps would result in a vibrant and sustainable Ontario power sector, while respecting the apparent desires of Ontarians for coal plant retirements and continued public ownership:

- Break OPG into at least two companies, each with a mixture of baseload and peaking capacity;
- Enter into a long-term lease for the Pickering nuclear facility while continuing recovery of the second mothballed unit, with the counterparty responsible for determining whether and when to restart the remaining two mothballed units;
- Create vesting contracts between the OPG successor firms and entities responsible for default supply, apportioned proportionally by load and structured to gradually reduce contracted volumes over a 10-year period;
- Sell up to 49 percent of each OPG successor company to Ontario individual and institutional investors to increase transparency, oversight, and financial discipline, while enabling the province to redeploy funds;

- Make the Ontario Independent Market Operator (IMO) responsible for determining resource adequacy and for contracting for new capacity to meet projected shortfalls, but under a system whereby bidders would be paid only a capacity payment; bidders would be expected essentially to bid the amount needed in addition to revenues from wholesale market or bilateral contract sales to meet return-on-investment criteria;
- Direct the OEB to revise generation licenses associated with coal-fired power stations such that the licenses expire over a period from 2007 to 2015; to further underscore the government's commitment to shut down the plants, any resource adequacy contracts issued by the IMO would commit the government to pay specified liquidated damages to the contract holder for each month any coal station operated beyond the expiration date set in the revised OEB license;
- Implement a process whereby default supply is procured through an annual full-require-

ments auction process, where the amount offered would be the residual needs over and above the vesting contracts with OPG successor entities; and

- Allow those customers wishing to enter into bilateral contracts with retailers or marketers to do so, provided they make their desires known prior to the default supply auctions and that their new contracts do not become effective before the subsequent default supply auction begins.

Those eager to eliminate the role of the market need to recall that one of the main justifications for relying on the market is that it allocates risks to those most capable, and incentivized, to manage them. As current experience with OPG shows, provincially owned companies that fail are slow to change management, and their losses are borne by the taxpayer. Ultimately, relying on market forces is the best stick the Ontario government can use to bust open the power sector piñata and ensure that the benefits of sustainably priced, reliable electricity supplies rain down on Ontario consumers. ■

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Endnote

1. OPG incentives to increase prices were intended to be moderated by the Market Power Mitigation Agreement (MPMA), which provided that OPG would rebate revenues in excess of Cdn. \$0.038/kWh to consumers on 90 percent of its hypothetical output. While the agreement provided for a variety of exceptions whereby OPG could benefit from higher prices, OPG faced fewer commercial constraints than would a private company when bidding lower than competitive levels. Thus, a strategy designed to lower peak prices and increase shoulder prices would have been unaffected by the MPMA, but could have been an effective deterrent to entry by peaking plants, for example.