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“GOVERNMENTS, MARKETS and ELECTRICITY SUPPLY”

I very much appreciate the invitation to speak to the Canadian Club of Toronto today. As I am deeply involved in Ontario's electricity industry, your invitation affords me an opportunity both to inform and to differentiate positively the electricity situation in Ontario from that of California and, hopefully, to clarify some of the confusion around so-called "deregulation."

Currently, North America accounts for about 30 percent of world energy consumption. Most of that energy is derived directly or indirectly from fossil fuels: coal, oil and natural gas. Each of these fuels, to varying extents, power electricity generation, along with available hydro and nuclear.

There are no indications that the level of North American energy consumption is declining. However, the fossil fuel mix is changing, e.g. less coal and more natural gas. BP-Amoco foresees the consumption of natural gas in the United States rising from its present 27 percent of energy consumed to 40 percent by 2010. Should this forecast prove to be generally correct, the consequent exploitation of new sources of gas and the implications for gas transmission and prices will have important economic consequences for producers, carriers, converters and consumers.

In light of this growth in consumption it should not surprise any of us that there are demand and price pressures. The State of California's electricity system has not only reflected these pressures, the system has suffered from inadequate planning, poor quality regulation and uninformed governmental interventions.

In the very brief descriptor of this talk which I provided to the Club, in advance of today, I referred to the "misinformation, disinformation, covering of backsides and ideological protestations" which have resulted from the electricity supply and related financial crises in California. Some of the utterances, both verbal and in print, exhibit if not almost overwhelming ignorance of the basic facts, then a keen desire to deflect responsibility and to obscure. About the kindest thing which can be said about some media coverage emanating from the United States, including "op ed" pieces, is that these observe the time honoured principle that the facts should never stand in the way of a good story!

The other, and more positive, side of the media coin is that those of you who read the Wall Street Journal and the London Financial Times, to give but two examples, will have noted, I trust, the excellent factual coverage, good analysis and sensible suggestions as to what might be done.

Here in Canada, we have been subject to the same full range of media coverage. On the one hand, one reads that the world of reliable electricity as we know it is in great danger because of what has happened and is happening in California. On the other hand, quite sensible and informed articles have been written pointing out that what has gone wrong in California arose out of very different circumstances than those which apply, or are intended to apply, for example, here in Ontario.

The late Professor George Grant, latterly of Queens University, who, I would argue, remains Canada's leading philosopher, taught me in an introductory logic and philosophy course at Dalhousie University in the early 1950's. (Yes, that long ago!) Professor Grant would have described the attempts to parallel Ontario's present and intended electricity supply, carriage and regulation with that of California as failing in logic in that there was an "undistributed middle term." The example of this particular failure of logic which Professor Grant used was, "This apple is green. This apple is sour. All green apples are sour!" I don't think that I have to extrapolate. I'm sure you take my point!

Strangely, in my view at least, all the facts giving rise to the current California situation were, and

are, in the public domain and, moreover, are not particularly complex. Additionally, this is not a situation in which only the benefit of ex post facto hindsight is 20/20. Both the quality as well as the line of sight have been very good for some time. All of the players "knew or should have known", as we lawyers say, and appreciated, the consequences of the various acts and omissions which took place over several years.

William Hogan, the research director of the Harvard Electricity Policy Group says that "California's situation is pretty much unique." At a most basic level, the root causes of California's electricity problems appear to be threefold. First, there was significantly inadequate in-state electricity generation capacity. Second, there was rigid regulation of retail prices, apparently without regard to supply, carriage and cost constraints together with a prohibition against distributors entering into long term supply contracts with generators. Third, linked to faulty regulation, the state government acted so as to shelter Californians from the realities of energy costs and supply - demand realities, which only made matters worse. These three, in combination, have produced most unpleasant consequences for Californian citizens and businesses.

The Californian economy has grown by about one-third in the past five years and yet no new generating plant had been built and commissioned for a decade. Until very recently, the processes for building new power plants in California appear to have been developed by Franz Kafka. Approvals process times were reckoned in multi-year periods and, seemingly, nobody wanted a power plant to be built anywhere near them.

The carriage of electricity is dependent always on the capacity and condition of the relevant transmission system or systems and, if supplied from outside the jurisdiction, the capacity and condition of inter-connections. It appears that in the case of California neither of these were adequate. Transmission congestion resulting from a combination of out-of-state power sourcing and in-state transmission constraints have exacerbated California's electricity problems.

However, albeit belatedly, from a capacity perspective some better news for California is that five new power plants are anticipated to be on line by this year end with eight more anticipated to come on stream in 2002.

Reacting to the electricity supply crisis, the California state government recently announced policies which would see billions of dollars spent on new power plants, the purchase of thousands of miles of transmission line and the state acquiring the right to seize existing power plants. In terms of scale, the objective appears to be for the state to control not less than fifteen percent of the capacity to supply and deliver power.

I fail to see that ownership has had anything to do with supply inadequacies or transmission congestion in California.

From the botched execution of an allegedly market based strategy, California appears to be moving now to a non-market, state controlled electricity sector. I hope that the patron saint of things electrical will watch over the Californian ratepayer and taxpayer. Not surprisingly, now concerns are being raised about the impacts on business, including both new investment and retention, of the electricity problems, new state energy policies and related cost impacts.

Some maintain that the main cause of the electricity crisis in California was a failure of regulation, or as it has been expressed, "seriously flawed deregulation." In rate terms, retail prices were so

rigidly controlled that there was no ability to contend with the rapid increases in wholesale prices driven by increased fuel costs and growing demand. Retail prices were held at about one-half of the wholesale price of power. Additionally, as I have pointed out already, almost unbelievably, the law in California prohibited electricity distribution companies from entering into long term contracts with generators. Thus the distribution companies were left at the mercy of an escalating spot market for power in the western US states and Canada and unable to pass on those costs.

Neither you nor I have time today for the litany of the many and various moves by California governments which have contributed significantly to the present problems. Therefore, for the short version, let me borrow from testimony given to the US Senate Committee on Energy and Natural Resources by Kit Konolige, Managing Director of Morgan Stanley Dean Witter.

Mr. Konolige said that what has happened in California is "mostly the predictable result of political meddling that disrupted the marketplace for electricity." He claimed that what California legislators "really wanted was permanently low electricity prices with no limits on consumption." Mr. Konolige points out that "under the 1996 law", (which ostensibly provided for a "market" system), "high prices were deliberately not passed through to consumers."

While the causes of the electricity problems in California are clear, further consequences continue to reveal themselves. While it is not my intention to list such consequences, I will point out just two which caught my interest particularly. On April 6th, California's largest electricity distributor, Pacific Gas & Electric, filed for protection of its distribution business under Chapter 11. Also last week, the Caterpillar Company announced that it is increasing production of its diesel power generation equipment by 30 percent, mainly for shipping to California and other western areas hit by electricity shortages. I note with some satisfaction that markets, including financial ones, frequently have the last say.

The California electricity problems are thought by some to be giving so-called "deregulation" a bad name. They fear that steps toward more open markets and more efficient utilities will be frustrated. Others take satisfaction in the possible continuance of old style regulation in which utilities are rewarded for what they spend rather than for output efficiencies, where customers are deluded into thinking that some governmental "Big Brother" or other can protect them from nasty cost shocks and that there is no need to conserve.

The reality, despite what is occurring in California, is that some sixty-two percent of Americans live in states which have adopted a market strategy for electricity competition. Such market strategies are working to the benefit of consumers, for example in the United States in New England and Texas and overseas in the United Kingdom and Germany. In some of these jurisdictions where electricity supply was regulated and now a competitive market exists, "deregulation" can be said to have taken place. In other competitive electricity markets in fact there has been no "deregulation" as such.

Because of this confusion, I want to spend just a few moments on the use, or perhaps misuse, of the word "deregulation." I believe this is important because "deregulation" has become something of a bogeyman, or other devil, at whose door all price rises, systems problems and related financial consequences can be laid. One may think that the clear meaning of "deregulation" is that something was regulated and now is either to be regulated to some lesser extent or not at all. However, including opposition to that which the Government intends for Ontario, one present usage of the word "deregulation" seems to have developed in accordance with the Humpty Dumpty rule of word

interpretation.

In "Through The Looking Glass," by Charles Dodgson, a.k.a. Lewis Carroll, (a work allegedly written for children, or at least for one little girl, Alice Liddell), this rule was stated. " 'When I use a word,' Humpty Dumpty said in a rather scornful tone, 'it means just what I choose it to mean, neither more nor less.' "

Those who are opposed to a competitive market for the supply of electricity, as distinct from its carriage, point to other jurisdictions where they allege "deregulation" has taken place and, in consequence, say they are opposed to "deregulation" in Ontario.

For example, it is said frequently that the United Kingdom "deregulated" its electricity industry. Aside from the nit picking point that in the UK the Scottish electricity industry and that of Northern Ireland were dealt with separately from that of England and Wales, the UK electricity industries were not deregulated. In fact, these and other UK utility industries moved from being state owned and directed, including for rates purposes, by governments. They were not regulated at all. Once sold by the state and in the private sector they became subject, for a first time, to new, quite stringent regulation, albeit regulation which provides incentives for performance.

When the UK markets were opened to electricity supply competition, generators became subject to the oversight of the regulator who, naturally, is required to have regard both to the financial viability of the generating companies, operating efficiency and asset condition as well as the interests of consumers, both individual and corporate. In each jurisdiction, the monopoly wires businesses, transmission and distribution, are subject to regulation by that same regulator. The UK electricity industry was not deregulated. It moved from there being no regulation to a regulatory environment.

Now, consider Ontario. Under the repealed Power Corporation Act, former Ontario Hydro, in effect, was self-regulated. Other than in what might be described as an advisory role, the Ontario Energy Board lacked regulatory jurisdiction. In 1998 the Harris Government passed the legislation which now governs the province's electricity industry, Ontario Hydro was dismantled and Ontario Power Generation, OPG, and Hydro One, both Ontario Business Corporations Act companies, were created.

Hydro One, which owns and operates virtually all of the transmission wires and about one third of the distribution assets in Ontario become subject to regulation by the Ontario Energy Board, the OEB. Also, the OEB is now regulating all of the other electricity distribution utilities in Ontario. When the market for commodity electricity opens, later this year or early next, suppliers, including OPG, will be subject to the market rules and regulations of the Independent Market Operator, the IMO, a not-for-profit regulator.

Thus, Ontario has moved positively from a situation in which its electricity industry was not being regulated to today where there are two systems of regulation, one for the monopoly wires businesses and one for the market in which electricity supply businesses will compete when the market is opened for such competition.

One of the fundamental things which will be enabled by these moves is to create a situation in Ontario whereby consumers will not pay more for electricity than a fair market price for the commodity, together with the cost of transmission and distribution of that electricity. That latter cost will earn a fair rate of return for the companies in question, subject to satisfactory performance, which, additionally, the OEB has stated, will be subject to incentives designed to benefit both

consumers and the wires based carriers.

Two conclusions appear obvious. One, the word "deregulation" does not apply to Ontario now or prospectively. Two, if you hear or read about the "deregulation" of electricity applying to Ontario, interpret this to mean the creation of a competitive market for electricity under a regulatory environment which has clear rules for all market participants and where adherence to those rules will be carefully monitored by the IMO in the interests of Ontario consumers.

Ontario's history of electrification is a combination of an early years' adventure story, decades of engineering excellence and service reliability and latterly problems in Ontario Hydro's nuclear generating sector and its related debt.

The Harris Government, which inherited the problems of the industry, including the Ontario Hydro debt, moved in 1998 to do three things: to dismantle the vertically integrated structure of what was Ontario Hydro, to bring Ontario's electricity industry within public regulation and to begin to address Ontario Hydro's debt.

The separation of generation from wires mirrored actions taken in many jurisdictions around the world. I've referred already to ^{the} advent of electricity regulation in Ontario. Portions of the Ontario Hydro debt were assigned to the two successor operating companies whose responsibility it is to re-finance so as to eliminate the provincial guarantee on that assigned debt. Additionally, the two companies, Ontario Power Generation and Hydro One, each contribute toward retiring the debt not so assigned, and deemed to be stranded, by remitting to the Province each quarter amounts equal to the corporate income tax which would be payable were the companies in the private sector and by declaring dividends on profits.

I tell you this so that you will appreciate that, structurally, the first key steps have been taken already by the Government of Ontario. The next steps will include the opening of the commodity electricity market to competition, both from within and outside Ontario. Premier Harris and Minister Wilson have made clear that the decision to open the market will be taken when the two regulators, the OEB and the IMO, indicate that the mechanisms for operation of the market are in place, have been tested and when the Government considers that the conditions are right, and not before. For my part, I heartily endorse this prudence.

All of this gives me a great deal of confidence to say to you, simply, that under no scenario I can conceive is the electricity situation in Ontario even remotely like that of California.

Ontario has a positive margin of electricity generation capacity within the province. California is in a considerable deficit position.

Ontario's transmission and distribution wires are fully capable of carrying to homes, offices and businesses throughout the province the electrical power they require. In California there is congestion.

The new generating and wires companies spun off from Ontario Hydro are functioning well, contributing to the reduction of the debt built up by Ontario Hydro and replacing provincially guaranteed debt. California is creating new and very large debt for electricity generation and transmission.

For me, the bottom line in Ontario is that there is a plan, that plan is in the public domain, the overall

situation is under good control, the regulators are functioning well, steady progress continues to be made against declared objectives and, subject always to force majeure, such as severe weather, I know the lights in Ontario will remain on.

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