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**WILL HOUSEHOLDS AND BUSINESSES WIN OR
LOSE IN ONTARIO'S DEREGULATED
ELECTRICITY MARKET?**

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Good afternoon. There has been plenty of talk and thousands of questions about the opening of the new electricity market in Ontario.

And there have been too many answers, on everything from IMO's to IPOs, the MPMA to the DRC and PILs, transmission to interconnects, LDCs and the OEB. If you're not fogged yet on this very, very complex subject, then you must do this for a living.

But I wonder whether people have been asking the most important question of them all: "Will households and businesses win or lose in Ontario's restructured electricity market?"

Electricity is an unusual commodity. It is a foundation for economic prosperity and activity. To provide this foundation, most large-scale hydro-electric development occurred within regulated monopolies that could support this capital-intensive growth in electricity supply.

But over time, all over the world, the limitations of regulated monopolies became clear, until jurisdiction after jurisdiction sought alternatives. This includes Ontario, where Ontario Hydro's debt skyrocketed, due to over-spending and inefficiency.

Competitive markets offer an established means to create more efficient systems. Ultimately, we hope that will be the case in Ontario, too.

But the experiences of other jurisdictions have been by no means uniform in trying to convert their electricity markets. So what is the outlook here in Ontario?

Ontario has some particular challenges in making the transition. First, we have an economy and a quality of life that is very much predicated on abundant, affordable electricity. In Ontario – with our manufacturing economy, our need for heat, water, air conditioning and technology in our daily lives – electricity demand is not very elastic, without contemplating major changes in our way of life and the way we do business.

Second, unlike many jurisdictions, we have the enormous burden of Ontario Hydro's legacy debt to shoulder, at the same time as we move to a new market.

And third, unlike many other jurisdictions, we have the systemic legacy of one, dominant, crown corporation as the sole provider of electricity in the market.

So what's the outlook? How will this impact customers?

As a manufacturer, we've seen price quotes for annual, fixed rate electricity contracts come down in the last few weeks, since the government announced a date for market opening, and the government deserves credit for improving certainty. These improved rates may also have been influenced by the poor economic outlook.

But in terms of pricing, Ontario electricity customers already absorbed a price increase in 2001 in anticipation of market opening – about 15 per cent on the wholesale rate. So to really compare pricing in the new market, you should really use 2000 rates as your baseline.

And the reality is that despite all the rhetoric, rates in the new market will be a lot higher.

To determine the real impacts of a transition to the new electricity market, we should ask:

- Are the rates we will be paying competitive with other jurisdictions?
- Do they reflect the abundance of hydro-electric and nuclear generating capacity in Ontario, which Ontarians paid for and are still paying for?
- Would our rates be lower if we had any true competition with numerous electricity providers?
- Are customers in Ontario widely exposed to the risk of price increases after market opens?

Ten or 15 per cent at market opening may not sound like much, but in this economy, it's a hit that goes straight to the bottom line. And all electricity customers, big or small, are exposed to the risk of undue price increases in the future, as a result of critical flaws in the new market, flaws that underpin the entire deregulation effort, and threaten its ultimate success.

It is these flaws I want to address today.

Namely: we will endure a long transition period between market opening and seeing true competition in the marketplace. And during this time period, the costs and risks of the transition are being placed disproportionately on the shoulders of customers like you and like Dofasco.

Unless addressed, we at Dofasco believe this will jeopardize the success of this transition, impact the prosperity of households and families, and dampen economic activity by making it more difficult – if not impossible – to compete at a time when we can least bear it. If we support the transition to competition, then we need to face the problems realistically and make some changes.

Otherwise, you and I will pay more than our fair share for the transition to a competitive marketplace. Through higher electricity rates, higher distribution rates, through new fees, and through debt repayment. And competition will not be seen in Ontario – at least, not fast enough – to offset this burden or to compensate us for having carried it.

And unless the open electricity market is actually examined through the eyes of the customer, which has not happened so far, it is very likely to fail.

Now let me be very clear about one thing here – I am very much in FAVOUR of a transition to a competitive electricity marketplace. I do NOT propose we return to the old system, because it didn't work either. Mike Harris' government was right to conclude the old inefficiencies were unacceptable.

So how do we make a competitive electricity market work in Ontario? How do we provide benefit to the customer? We must ensure three things:

First, we must make sure that Ontario Power Generation and Hydro One asset sales and privatizations maximize the paydown of the stranded debt, and make sure that as long as these are government-owned entities, we the customers have first-call on the cash these companies generate until all the stranded debt is paid.

Second, Ontario Power Generation, or OPG, must be broken up further and faster to ensure competition in the new marketplace.

And third, customers must be given greater protection from potentially predatory and volatile pricing until true competition emerges, and market forces prevail.

Let me elaborate on each of these three points.

First, the stranded debt.

I don't deny it needs to be paid. It's our debt and our responsibility to pay it down. On the positive side, one of the things it gave us was a large base load of nuclear generated electricity, which can be produced at a lower variable cost than fossil-fuel-based electricity. This, in combination with Ontario's hydraulic assets, has given Ontario stable blocks of affordable electricity, supporting our economy, creating jobs and enhancing our quality of life.

But as long as the stranded debt is on the books, every household and business in Ontario is paying for it. Each of us is currently paying at least nine per cent more than we did at the beginning of last year on our power bills, in order to help pay down the stranded debt, or more precisely, the residual stranded debt, which is the part that cannot be reasonably repaid through future cash flows of Ontario Power Generation and Hydro One.

This is a problem that becomes more urgent in an open market, where the debt reduction charge could easily translate into a competitive disadvantage for every customer in Ontario, because neighbouring jurisdictions – which will be buying affordable Ontario electricity – will not have to pay the debt reduction charge, either on their power, or the power they import from Ontario.

So New York could conceivably buy Ontario power at a lower price than Ontarians. What's wrong with this picture?

That's why it's important to pay off the debt as quickly as possible, and do so in ways that cause least injury to customers. The sale of Hydro One and OPG assets, and the privatization of those companies are one-time opportunities to do just that, if we don't squander them. Everyone in this room has a financial stake in the outcome.

It was encouraging to hear the government's intentions to apply the proceeds from Hydro One's IPO to the stranded debt. I would hope that proceeds from OPG's IPO later this year are similarly earmarked for debt reduction.

Having said that, the potential proceeds from the Hydro One IPO have been described as being in the \$5-7 billion range. Now I have to ask: if it does end up at the low-end of this range, can we be assured that this is maximizing the proceeds of privatization, given all the options in front of government? And furthermore, how will that number compare to the amount of stranded debt attributable to Hydro One?

There was a minor tempest in a teapot debate in the media a month or two ago over exactly how Hydro One assets should be divested. However it is sold, through an IPO or by other means, Hydro One will remain a regulated monopoly. What's important is that we maximize the value we get for the asset to pay down the stranded debt.

Our formerly public utilities – built with taxpayer dollars – have also been using their internal cash flows to finance growth and acquisitions.

This is our capital being used... free cash flow that could otherwise be used to pay down the stranded debt. We still hold the debt, without interest, and with no clear terms of repayment. There isn't a lender in the country who would accept those terms. And frankly, Ontario's hydro customers should also demand more. Hydro One has acquired 88 of Ontario's municipal electricity utilities at a total cost of around \$600 million. Some of these acquisitions were at significant premiums, and there was no public consultation on what is clearly a public policy issue.

The question this raises in my mind – especially considering the higher cost of capital in equity markets – is this: will the market pay a price in an IPO that reflects what Hydro One paid for those assets? I don't know.

Instead of using capital for growth, these utilities should be obligated to pay down the stranded debt first. It's our money that's still paying off the remaining debt. That is why – until the debt is fully retired and as long as the government owns these utilities – Ontario electricity customers should have first call on the money generated by the utilities, above what they need to sustain normal operations.

Let me move on to my second point about true competition in the marketplace.

When electricity deregulation was announced, the government said they wanted to give consumers “the power of choice”. The idea was that true competition would provide greater efficiency and more competitive rates to consumers on a sustainable basis.

This was a great starting point and an idea we at Dofasco fully support, but somewhere along the line, this objective was lost. So when the electricity market opens on May 1, we will indeed have a restructured market and deregulated rates, but we will NOT have a competitive market.

This is the heart of the issue. We have all the apparatus of a market. The only thing missing is competition.

Non-profit Ontario Hydro is being replaced by for-profit Ontario Power Generation to generate power. One dominant player to another, but without the regulatory constraints on electricity rates.

I've heard some people saying they've had several different companies knock on their door at home, trying to sell them fixed rate electricity, so that must be a sign of competition.

It's not. All of those retailers are back-stopped by the same physical supply of electricity, where the base price is set. There is still just one dominant source of electricity – OPG – which is setting prices to re-sellers for profit, who in turn sell it to homeowners for a second profit.

By the way, those fixed rate contracts may offer predictable pricing, but they are coming at very high premiums, due to lack of competition at the generation level. Consumers who once paid around four-and-a-half cents per kilowatt hour are signing contracts at around five-point-nine cents an hour. That's a hefty increase, and it doesn't include increases the customer will pay for distribution, transmission and regulatory costs, as well as the stranded debt at point-seven-cents per kilowatt hour.

Clearly a pre-condition to lower retail rates is more competition in electricity generation.

At this moment, OPG controls in the neighbourhood of three-quarters of Ontario's electricity production. This won't change significantly anytime soon.

The industrial electricity customer is in the same boat. When we first went to the market for pricing a year ago, the market was extremely thin. We received only a handful of responses to Requests for Quotations. The market has improved somewhat since the government announced market opening, but there is still no real evidence of true price competition. It's not even close.

Some are positioning this as a chicken-and-egg debate... they say we won't have competition UNTIL we open the market. They say, open the market and allow competitive forces to evolve.

But the point is, until we're *assured* true price competition, the customer is at risk. And the transition period won't be a matter of months. The current plan is that it will take about a decade. This is far too long for customers to carry the burden and risk of a market transition. I can tell you that we have been to market for pricing, and electricity prices are going North, not South.

OPG has highlighted the fact that the Bruce nuclear plant has been sold to another company. That's roughly 3,000 megawatts out of OPG's 25,000 megawatts of generation capability. So while the de-control of Bruce is a step in the right direction, it isn't enough to bring about serious price competition anytime soon.

In fact, OPG has only to de-control or divest 4,000 megawatts worth of generation within three and a half years of market opening. This doesn't begin to touch the important hydraulic and operational nuclear assets that control base load in Ontario – and it is these sources of big base load that are key to any real competitive dynamic.

4,000 megawatts out of around 25,000. OPG could still control around 80% of their electricity capability in 2005.

It's not until ten years after market opening that OPG is required to reduce their control to only 35%, which some argue is still far too much market power. Most experts say 20 percent is a better target.

In the meantime, OPG has market dominance, and it has the ability to set rates.

This is not quite living up to the government's "power of choice" promise. To give him credit, Minister Wilson is pretty candid on this point. In the legislature a couple weeks ago, he said, "John Mayberry's problem is that we haven't gone fast enough and that we haven't sold enough of Ontario Power Generation to have enough competition so Dofasco can shop around for prices." He's right. He and I are on the same page.

I do value the Minister's candour, but we need more than that now. We need *a plan* to show exactly how we are going to fix this problem – the fact that the key foundation of the restructured energy market is at present made of straw and feathers. Because in the absence of competitive forces to mitigate against price risk in electricity markets, this glaring problem will have an impact on my company every day.

It will also have the same effect on every Ontario business, hospital, school, church, apartment renter and homeowner. It's got to be addressed.

And I think this has to be an issue put in front of every one of the current Conservative leadership hopefuls. We need to know where they stand, because this is an issue that will need leadership. Despite years of planning and market design, the nitty gritty question of how we get true competition into the market has yet to be adequately addressed.

I believe the only way to obtain realistic, competitive pricing is to have true competition in our restructured electricity market. Every OPG asset needs to be on the table – not just the marginal stuff. And by the way, at the same time consumers should not have to BUY competition by letting these assets be sold at prices that would increase the burden of stranded debt on customers. We need competition for the benefit – not at the expense of – customers in Ontario.

And frankly, we need to take the decision-making power about how and when these assets are divested away from OPG. They have been put in a conflict of interest in this respect, and it needs to be resolved.

My last point is about potentially predatory and volatile pricing, which is a result of OPG market dominance and the lack of competition I just described.

In the new market, customers will face layers of new fees. Some were embedded in our old rates, some were hidden on the government's books, and some are brand new.

We will pay one company for generation. We will pay another for transmission and another for distribution. At each step of the way, a profit necessarily needs to be made by providers. And I acknowledge part of those profits – which we'll all contribute to – will go towards the stranded debt. But then we will pay for *the rest* of the stranded debt left over from Ontario Hydro. And we will pay for a Market Operator to make the rules and handle all the transactions.

The only thing that hasn't changed is that there is still just one customer at the end of this chain. And the buck stops with the customer. Costs and profits and regulatory fees will be passed down the chain and end up in our mailboxes.

In addition to the need to introduce competition or other measures to counter-balance these upward forces on rates, we also need to be concerned about volatility. We have seen extreme price volatility in other markets – times when electricity prices climb to 20 or 30 times their normal level.

How can rates be so potentially volatile? Electricity is a unique commodity. We can't store it... it's either there when you need it or it's not. So in times of high demand – like during a heat wave when we all have our air conditioners on – prices rise to reflect the state of the market at that instant. High demand and constrained supply means higher prices.

Right now, Ontario consumers are partially sheltered by something called the Market Power Mitigation Agreement, or MPMA, which provides a rebate on a portion of the power we use. It is a recognition that in the absence of a truly liquid, competitive market, there is the potential for excessive volatility and few ways for customers to shelter themselves from this risk.

Unfortunately, this rate protection is set to be phased out long before we get real competition. Further, the MPMA only applies to the spot market. It doesn't extend to the contract market. As a result, many of Ontario's manufacturers are particularly at OPG's mercy. We are all vulnerable to price volatility, unless we fix our prices at potentially significant premiums.

And we do run the risk of price volatility.

Let me give you an example, one that actually happened last summer. Ontario set an all-time demand record last August. Our system was robust enough to handle the demand. That's the good news.

But pricing was anything but reliable. Last summer, Dofasco's on-peak, direct electricity prices went to a high of almost \$1,600 per megawatt hour. We had a stretch of 130 hours where we paid \$375 per megawatt hour. It's worth noting that these prices had nothing to do with the cost of producing electricity. So you can see how volatility can create huge profits for producers of electricity.

Compare this to the regulated electricity rate you pay today, which depending on where you live, is probably in the \$43 per megawatt hour range for electrons.

Now imagine the impact this kind of price volatility could have on your household bill. In our case, we had to shut down a production line, for almost three weeks. We cannot operate business this way, and be successful.

In the open market, *all* customers will be affected by price volatility.

OPG has rationalized this by saying that when we do encounter this price volatility in the restructured market, companies like Dofasco should look on it opportunistically. They say we can routinely shut down our operations and sell electricity back into the market, for windfall profits, if we have a fixed price contract.

There's many, many things I don't like about this suggestion, but let me outline just a couple. First, yes, perhaps we could make more money doing that, but we wouldn't be able to serve our North American customers with Just-In-Time service and maintain our status as a Tier One supplier. Our product is steel. We are not electricity brokers. There is a competitive cost to OPG's strategy, which OPG perhaps doesn't recognize, because they have not yet had experience competing to keep a customer. Could OPG keep industrial customers if they couldn't provide a reliable stream of electricity, while their competitors could?

And there are costs associated with managing this kind of price risk if we do want to keep shipping steel. We can carry more inventory and hope our crystal ball is accurate to anticipate our customer's needs correctly.

Or we can buy very expensive hedges – insurance policies against volatility that come at significant premiums. Premiums set by OPG, who, by the way, also controls supply in the market.

This is really a philosophical question. Do we want to move away from a manufacturing economy in Ontario and instead rely more heavily on exporting electricity? Perhaps this is a question policymakers should be asking themselves. The transition to a new electricity market should not force us to make these kinds of choices. The tail is wagging the dog.

What happened to the focus on a competitive manufacturing base as vital to Ontario's economy?

I just spent some time outlining a variety of concerns we have with electricity restructuring.

I said that unless the stranded debt is paid down quickly, unless OPG is sold off faster and further, and unless customers are protected from potentially predatory and volatile pricing during the transition, then this restructuring exercise will likely fail.

And I define failure as the process of making us all poorer. Which will hurt us all at home, and it will hurt us at work. And before long, it will even hurt OPG and Hydro One.

We've spent two years studying this issue. Over about a year of that time we have had discussions with policymakers and politicians, telling them that we think there's a problem. We've been told that we're a lone voice on this issue, and that electricity deregulation is proceeding as planned.

But we also spent time talking to other companies and to consumer groups, to see what they think. They're coming to the same conclusion we are. And they're also being told they are lone voices on this issue.

I found that all of us "lone voices" agree on one fundamental point: the costs and risks associated with the transition to a competitive market need to be re-balanced with greater consideration to the customer.

Today, the customer is NOT a big enough part of the equation. We're putting all the emphasis on making OPG and Hydro One profitable if only as private monopolies, and in making Ontario attractive to other generators so they will invest here.

These objectives are not without merit, but the scales have tipped too far. My industry is being made to subsidize transition in their industry, and that is just not realistic. We have our own market pressures to manage. The steel business is truly competitive, and no-one is going to let me pass on rising electricity prices to our customers. OPG should not have free reign to pass on its transition costs either.

If the government doesn't make some changes to this process, we risk turning OPG into an inefficient, comfy, virtual private monopoly, as any industry in a monopoly situation might become. And if this happens, the tough decisions they announced last week will be for nought.

Did anyone perched on the bow of the Titanic really think it was of no concern to them as the stern began to sink? The view may be better at the bow, where the generation and transmission companies sit. But we're all in the same boat, and the plight of the customer is what will define the success of the new electricity market. For everybody.

And in this economy, we're all close enough to the waterline already. We don't need a scheme for deregulation that ties an anchor to us as well. Risk and cost need to be rebalanced.

Because here's the bottom line: if you can't serve the customer, you can't succeed. We can't succeed running businesses like Dofasco unless we are focused on our customers. We can't succeed as a province if we stop attracting new manufacturing investment. And we can't succeed as an economy if we put ourselves at a competitive disadvantage to neighbouring economies.

But listen... it doesn't have to be all bad news. We have *almost* all the ingredients for success. I have to give credit to Mike Harris for the bravery he displayed in starting this process, and to Jim Wilson for accepting responsibility for this complex challenge, because the old system clearly needed fixing.

We just need to fix a couple things, like getting some real competition and dealing with the stranded debt, which can also be seen as an opportunity. If we do these things, we may find ourselves with a competitive *advantage* relative to neighbouring jurisdictions.

So, how can the government fix this – how can they re-balance the equation to serve the customer more equitably?

That's the question government needs to *ask*. And it's the question they need to *answer*. And it's urgent that they do so. It will not wait for ten years.

We are in favour of a competitive electricity market. But what we see coming at us is an open market without competition. A market where the customer will be exposed to price risk and will be forced to carry the costs of transition.

And that will push every Ontario home and business owner closer to the waterline. So you can learn to tread water, or else join a growing group of electricity customers who are asking for change. You should look at this issue, and assess what it means to your business, and to your household. And if you're concerned, call your MPP and get engaged.

We have everything we need in Ontario for a vibrant electricity industry, a competitive manufacturing sector and a sustained quality of life. But it's time to get decisive and make some realistic choices.

Thank you for your time today.