

CCRE Commentary

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IN THIS ISSUE:

Reforming Ontario's Electricity Distribution Sector

by David McFadden

Council for  Clean & Reliable **Electricity**
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Declaration

This paper is based on the report "Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First," which was prepared by a panel appointed by the Ontario government. The panel members were Murray Elston (Chair), Floyd Laughren and the author of this paper, David McFadden. This paper is the work of the author alone and does not necessarily reflect the views of the other panel members or the Government of Ontario.

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Reforming Ontario's Electricity Distribution Sector

David McFadden

Ontario electricity costs could be lowered by some \$1.2 billion over 10 years if the province embraces a recent government task force report that advocates a more efficient electricity delivery system. These savings would come mostly from administration cost reductions and would amount to \$70 annually per customer. "Ontario's electricity distribution sector is at an historic turning point," concluded the task force in its report released in December. "It is now up to all the partners in the electric distribution sector, the government . . . and the regulator to deliver on the challenge . . . Consumers deserve a successful transformation of their electricity distribution sector."

In releasing the study, then-Energy Minister Chris Bentley promised to ensure "our energy system remains strong while delivering savings and efficiencies for ratepayers."

The report, *Renewing Ontario's Electricity Distribution Sector: Putting the Consumers First*, establishes a clear path for achieving those three goals. It says a stable, more efficient and economical electricity delivery system can be achieved by reducing substantially the large number of distributors operating in the province while modernizing the system's aging hardware.

I served on the panel with fellow former provincial legislature members Murray Elston and Floyd Laughren. Although coming from different political backgrounds, we agreed that the current distribution system "will not serve the citizens of the province well in the decades to come," although it has done so in the past. Between May and October last year, we received over 80 submissions from business and consumer organizations, financial institutions, municipalities, unions, energy experts, energy associations and local distribution companies (LDC). I was struck by the repeated concerns raised by business organizations such as the Canadian Federation of Independent Business, Canadian Manufacturers & Exporters and the Retail Council of Canada about how the rising cost of electricity is detrimental to our economy.

Most submitters agreed that substantial change is needed to meet the future needs of consumers while enhancing Ontario's economic competitiveness. Here is how we framed the electricity distribution challenge: "The nature of electricity generation is changing, and computers are turning electricity distribution into a digital, high-tech endeavour. . . Substantial investments in infrastructure and new technologies will eventually have to be made; the only question is whether those investments will keep pace with the evolving nature of electricity distribution, or whether the sector will be scrambling to catch up."

In our report, we trace the sector's growth from the start of the 20th century to its current state. We note that electricity has been vital to the economic development of the province, stating that: "Electricity is a critical building block not just of Ontario's standard of living, but also of its ability to compete economically. In a highly competitive world, it is vital that electricity be delivered in a most efficient and cost-effective manner."

"More economical electricity delivery can be achieved by reducing substantially the large number of distributors."

At the same time, we point out that Ontario currently has the most fragmented distribution sector in Canada, which is a “a product of history rather than the outcome of rational planning.” While Ontario has 80 LDCs, most other provinces are served by just one or perhaps two major distributors and in some cases fewer than a half dozen smaller ones. Of Ontario’s 80 electricity distributors, 77 are rate-regulated by the Ontario Energy Board (OEB). As might be expected, there is a wide range of sizes among LDCs from the 1.3 million customers served by Hydro One to the 1,208 customers for Hydro 2000 in Alfred, Ont. In fact, 36 per cent of Ontario’s LDCs serve less than four per cent of the population.

Such a fragmented distribution system comes with a price. Operations, maintenance and administration costs are significantly higher per customer in smaller LDCs versus larger ones – by 75 per cent on average. As well, average financing costs of long-term debt for smaller LDCs are significantly higher than for larger LDCs. Other related cost pressures include the duplication of facilities and distribution equipment throughout the province along with multiple regulatory proceedings and enforcement activities arising from the large number of distribution licensees.

In our report, we stress the need to look forward and meet the distribution needs of 2022, not backward to what was adequate in 2002. The LDC sector of the future must have a renewed customer focus, access to increased investment capital for innovation and upgrades, the capacity to implement and operate smart-grid technology, and have a structure that enhances cost efficiency for the benefit of consumers and the overall economy.

RECOMMENDATIONS

CONSOLIDATION

- LDCs in Ontario should be consolidated into eight to 12 larger regional distributors. Two of these regional distributors would serve northern Ontario, one for the northeast and the other for the northwest. The remaining six to 10 regional distributors would be located in southern Ontario and typically each have a minimum of 400,000 customers.
- The current situation requires immediate action, and consolidation should be completed within two years of accepting the report’s recommendations.
- Current LDC owners should receive equity opportunities in the new regional distribution system in proportion to the value of the assets contributed to create these consolidated utilities.
- LDCs who reach a successful voluntary consolidation agreement within the initial six to nine months of the two-year implementation period and submit a license application within the two years would be allowed to recover their legitimate transition costs. As well, LDCs involved in any voluntary consolidation would not be required to go through an OEB review since such mergers would be deemed a net benefit to customers.
- Savings from the increased efficiency of new regional distributors should be shared equally between shareholders and customers.

COST SAVINGS

- The report identifies some \$1.7 billion in consolidation cost savings produced by economies of scale, reduction of duplication, lowering of borrowing costs and the better use of capital. The net benefit over 10 years would be approximately \$1.2 billion, even after some \$500 million is spent on transaction and transition costs.

“We need to look forward and meet the distribution needs of 2022, not backward to what was adequate in 2002.”

“We can achieve a distribution system that better meets the changing needs of the consumer.”

TRANSITION ADVISER

- The province should appoint a transition adviser to oversee the consolidation process. If the adviser finds that progress is insufficient during the six to nine months allotted for voluntary consolidation, legislative and/or regulatory action should be implemented to achieve the targeted results within the two-year period.

NEW INVESTMENT

- New investment in the distributor sector, notably from pension funds, should be encouraged. The province should enter into negotiations with Ottawa on a tax agreement that would facilitate the removal of the transfer tax on the sale of LDC assets, making investment more attractive.

INFRASTRUCTURE ONTARIO

- Infrastructure Ontario should stop providing subsidized credit facilities to LDCs since the new regional distribution utilities will be able to secure required financing at competitive rates.¹

GOVERNANCE

- At least two-thirds of the board of directors for the new regional distributors should be independent.² (Even better, the boards should be comprised solely of independent directors.)

CONCLUSION

Given the support for meaningful reform from the electricity distribution sector, its stakeholders and the province, we are optimistic that our recommendations will lead to a “stronger, more innovative distribution system that can meet the changing needs of the consumer and the province.” And we are confident that the “leaders of the distribution sector have the vision and the skills to forge a new era in the distribution of electricity in Ontario.”

REFERENCE

Renewing Ontario’s Electricity Distribution Sector: Putting the Consumer First. Report of the Ontario Distribution Sector Review Panel, Ontario Ministry of Energy, December 2012. Available at <http://www.energy.gov.on.ca/en/ldc-panel>.

¹ The savings will accrue to taxpayers from reduced provincial debt-servicing costs through a combination of a higher credit rating and lower debt obligations.

² An independent director is a person not associated with a municipality that is a LDC shareholder, either as an elected municipal council member or municipal official.