

Smart Governance for Smart Electricity: Moving Forward from the Auditor General's Report

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Waterloo Institute for Sustainable Energy



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INTRODUCTION

This document summarizes presentations and discussions at the Smart Governance for Smart Electricity conference organized by the Council for Clean and Reliable Electricity (CCRE), the Richard Ivey School of Business and the Waterloo Institute for Sustainable Energy on April 12, 2012. The conference focused on a range of governance and performance issues in the electricity sector raised by the Auditor General of Ontario in his 2011 Annual Report.

The conference's primary goal was to identify those parts of the electricity system most in need of alignment and where efforts could help reduce social friction. The higher-level goal was to help Ontario achieve economic competitiveness through a reliable, affordable and secure electricity system.

The sessions were structured to probe two areas of governance—Policy Options and Political Considerations. The Policy Options session considered policy, regulatory and financial initiatives that could help improve governance, while the Political Considerations session explored the political dimensions of policy changes and explored the practicality of making such changes.

SESSION 1: THE AUDITOR GENERAL'S PERSPECTIVE ON ONTARIO'S ELECTRICITY SECTOR

The conference commenced with Jim McCarter, the Auditor General of Ontario, presenting key findings from the electricity sector audits presented in his Annual Report. The Auditor General (AG) noted that his office conducted three audits in the electricity sector in 2011: Regulatory Oversight, Stranded Debt & the Debt Retirement Charge, and Renewable Energy Initiatives.

Regulatory Oversight

As part of the electricity sector audits, the AG reviewed the role of the Ontario Energy Board (OEB) in protecting consumer interests and promoting reliable, sustainable electricity at a reasonable cost.

The AG report raised several key issues concerning the OEB's ability to perform its regulatory duties. Firstly, the OEB's jurisdictional oversight covers only about 50 per cent of the total charges on a typical

bill. For example, the OEB has no regulatory oversight with respect to the portion of electricity charges arising from long-term contracts between suppliers and the Ontario Power Authority (OPA).

Secondly, the OEB has no oversight over the debt retirement charge that consumers pay each month. Finally, the OEB oversees only about \$190 million of the \$900 million collected from ratepayers to administer and operate the Ontario electricity market.

Among the areas where the OEB does have jurisdiction, the rate application process—a quasi-judicial process requiring utilities to defend their rate requests at public hearings—has been identified as quite costly and complex for small and mid-size utilities.

Finally, the AG noted concerns about the oversight of electricity retailers. Most consumers are unaware that although the OEB licenses all retailers, it does not have authority over the prices they charge. The AG believes that the OEB should play a more proactive role in protecting consumers, given that it licenses these entities. In some situations, consumers who have independently negotiated long-term supply contracts could be paying between 35 per cent and 65 per cent more for their electricity consumption than they would have under the Regulated Price Plan set by OEB.

Stranded Debt & the Debt Retirement Charge

Stranded Debt and the Debt Retirement Charge (DRC) arose from the 1999 restructuring of Ontario's electricity sector and the breakup of Ontario Hydro.

The Electricity Act 1998 provided a long-term plan to service the stranded debt, in which a partial \$7.8 billion, called “residual stranded debt,” would be collected from electricity consumers via a separate charge. Over a decade since the 2000 incorporation of the DRC in electricity bills, approximately \$8.7 billion in DRC revenue has been collected, exceeding the original \$7.8 billion.

As part of his review, the AG focused on the Stranded Debt and DRC as well as the regulations that authorize the collection or repayment funds as specified in Section 85 of the Electricity Act. Section 85 requires that the Minister of Finance “from time to time” determine both the total stranded debt and

the residual stranded debt, and make those determinations public. The AG considered the section to be somewhat open to interpretation and found that, as a result, implementation has been left to the discretion of the government.

His office solicited a comprehensive legal opinion on the seemingly open-ended elements and to shed light on the intent of the language in the legislation such as “from time to time,” what constitutes being made public, what residual stranded debt legally means, how the outstanding amount is to be determined, and when the collection of the debt retirement charge is to end. The AG concluded that the Minister should make a formal determination of the outstanding amount of the residual stranded debt in the near future and make this determination public.

Renewable Energy Initiatives

The third audit evaluated whether the Ministry of Energy and the OPA had performed an adequate analysis to ensure cost-effective procurement of renewable energy resources and that they had implemented appropriate planning mechanisms with respect to integration of renewable energy resources.

The Green Energy and Green Economy Act, 2009 delegated authority to the Minister of Energy to supersede many of the government’s usual planning and regulatory oversight processes. As a result, the government was able to further its renewable energy initiatives rapidly over the next few years.

The AG’s 2011 Annual Report made four significant findings in this area. First, he found that although directives issued by the Minister would allow wind and solar projects to be expedited, no comprehensive evaluations were performed to assess the business case and “downstream” impacts of these directives.

Second, in 2009 the Ministry anticipated a modest approximately one-per-cent annual increase in electricity bills as a result of a newly introduced Feed-in Tariff (FIT) program. However, a year later the Ministry predicted that residential electricity bills would rise about 7.9 per cent annually over the next five years. It said that more than half of the increase would be due to incentives for additional renewable energy and the costs related to integration of these intermittent resources into the transmission and distribution infrastructure. Given that demand growth for electricity would remain modest, the AG

found as a result that ratepayers may have to pay renewable energy generators between \$150 million to \$225 million a year under the FIT program not to generate electricity.

Moreover, Ontario has higher prices compared to other jurisdictions that have FIT programs, yet there are no mechanisms to limit or moderate the cost impacts arising from implementation of FIT directives. The AG noted that the OPA – the expert agency – had also recommended reducing FIT prices on several occasions, but the government believed that it was a reasonable trade-off to offer higher prices and long-term contracts at these prices to create investor confidence.

However, one price reduction was made in August 2010, five months after it was proposed, and the AG estimated that had the reduction been made at the time it was recommended, additional consumer cost savings would have been about \$950 million.

Third, while the OPA is the designated electricity system planner for the province, its first long-term energy plan was suspended by the government in 2008. In 2010, the Ministry put forward its own Long-Term Energy Plan (LTEP) to guide OPA's planning. The AG felt that this change in planning responsibilities created confusion among stakeholders and undermines the effective functioning of the entity charged with electricity system planning.

Finally, the AG discussed some of the issues related to an agreement the Ministry of Energy negotiated with a Korean consortium and noted that a formal business case analysis was not performed. The AG also questioned the government's green job creation projections given that many of the new jobs were temporary construction work and higher electricity prices threaten existing jobs in the manufacturing sector.

SESSION 2: MOVING FORWARD: POLICY OPTIONS

The second session focused on policy options for improving governance in Ontario's electricity sector.

Creating a Stable Policy Environment

Guy Holburn, an energy sector expert at the University of Western Ontario's Ivey School of Business, examined policy reforms that would help create a more stable policy environment. Specifically, Holburn urged rolling back ministerial directive authority over the decision-making autonomy of expert agencies, such as the OPA and the OEB. He said such a restriction on government discretion would improve policy stability and help attract new investment in energy infrastructure.

According to Holburn, two policy-making trends have developed recently in the Ontario context. First, there has been a shift toward more direct political control over expert agencies and boards since 2003 and second, cabinet shuffles have resulted in frequent changes in ministerial responsibility for energy.

The shift toward more direct political control is manifested by energy legislation over the past 10 years allowing the Ministry to accrue greater power. For example, the Electricity Restructuring Act of 2004 and the Green Energy and Green Economy Act added 14 and 29 new directive clauses respectively. The scope of these directives deal with broad policy goals such as renewable-energy capacity targets or conservation and demand management, as well as policy details such as FIT pricing, timing and location of new generation build, domestic-content requirements, competitive and non-competitive processes, or even the format of the electricity bill. It was found that ministers have not been shy in imposing such authority. Between 2005 and 2011, ministers issued an average of 13 such directives annually.

Compared to other OECD jurisdictions, Ontario is an outlier in terms of electricity governance structure. In most OECD countries, power agencies operate with a greater level of independence from government. Typically, energy policy objectives are specified in legislation. While the executive branch of government appoints the head of regulatory agencies, equivalent to the OPA and OEB, it does not possess directive authority over decision-making by those agencies. It is the responsibility of regulatory agencies or boards to design rules and regulations for policy details, monitor compliance and provide expert advice, while utilities assume the role of implementation.

There are clear downsides in governance models that vest decision-making in directives as opposed to legislation. There exists the risk of costly policy mistakes, because no rationale or cost-benefit analysis is required for ministers. Public consultation is not required, and there are no transparency mechanisms to ensure accountability. As well, adherence to a long-term policy agenda is not required. Indeed, expert agency advice can be simply ignored. It is a climate in which policy surprises and instability abound. Given the vacuum in checks and balances, energy policy in such an environment can be exposed to short-term political pressures and ministerial rotation.

The change of ministers and policies in recent years illustrates the point. In 2006, Energy Minister Donna Cansfield adopted renewable capacity targets of 2,700 MW by 2010 and started the Renewable Energy Standard Offer Program (RESOP) initiative. One year later, the capacity target was boosted to 15,700 MW when Dwight Duncan assumed the portfolio. Then, in 2008, the new minister, Gerry Phillips, suspended RESOP entirely, less than two years after it had begun. When George Smitherman succeeded Phillips a year later, he reinstated RESOP for bio-gas but suspended renewable capacity targets and the supply mix planning process. The following year, his successor, Brad Duguid, launched a new feed-in tariff (FIT) program and established capacity targets of 10,700 MW by 2018. When Chris Bentley took office in 2011, the sixth minister in six years, he brought forward the time horizon for capacity targets to 2015 and reduced FIT rates.

Against this backdrop of constant policy change, a 2010 Ivey research survey of renewable energy firms active in Canada provides some key insights. The survey showed that in Ontario “policy stability” ranks 14th in favorability among 15 business climate factors. However, policy stability is highly valued by firms seeking to invest in the energy sector. In fact, it is the second most important factor in wind firms’ investment location decisions.

A broad industry stakeholder survey conducted in Fall 2010 identified several reform priorities. “The principle of independence of agency decision-making should be formally stated in legislation” was rated as highly important by 93 per cent of respondents. Nearly three-quarters (72 per cent) also considered it highly important to have major policy objectives “specified in legislation rather than in directives.”

MOVING FORWARD FROM THE AUDITOR GENERAL'S REPORT

Robert Warren, who specializes in energy issues at Weir Foulds LLP, commented on two of the three AG's 2011 electricity-related audits, Renewable Energy Initiatives and Regulatory Oversight.

With regards to the Renewable Energy Initiative, Warren began by revisiting some key findings of the AG's report:

(a) "Although the Ministry consulted with stakeholders in developing the supply-mix directives, the LTEP, and the Green Energy and Green Economy Act, billions of dollars were committed to renewable energy without fully evaluating the impact, the trade-offs, and the alternatives through a comprehensive business-case analysis. Specifically, the OPA, the OEB, and the IESO acknowledged that:

- no independent, objective, expert investigation had been done to examine the potential effects of renewable-energy policies on prices, job creation, and greenhouse gas emissions; and
- no thorough and professional cost/benefit analysis had been conducted to identify potentially cleaner, more economically productive, and cost-effective alternatives to renewable energy, such as energy imports and increased conservation."

(b) The Ministry rejected the OPA's proposed nine per cent reduction of FIT prices for electricity from ground-mounted solar projects, something the AG estimates would have reduced the cost of the program by about \$2.6 billion over the 20-year contract terms.

(c) The OPA recommended, in February 2010, a cut in the FIT price paid for power from micro-FIT ground-mounted solar projects. The AG observes that, had the revised price been implemented when first recommended by the OPA, the cost of the program could have been reduced by about \$950 million over the 20-year contract term.

(d) With respect to the agreement with the Korean Consortium, "no economic analysis or business case was done to determine whether the agreement with the consortium was economically prudent and cost-effective, and neither the OEB nor the OPA was consulted about the agreement."

(e) Electricity ratepayers may have to pay renewable energy generators under the FIT program between \$150 million and \$225 million a year not to generate electricity.

The AG went on to suggest that independent oversight for those decisions was non-existent. The vacuum could be attributed to the 2004 amendments to the Ontario Energy Board Act and the Electricity Act, which created a system of decision-making with four different entities: the OEB, the Independent Electricity System Operator (IESO), Ontario Power Generation (OPG) and the Ministry of Energy. Each had discrete roles, thus substantially reducing both effective oversight and accountability.

The Green Energy Act further reduced that oversight by expanding and strengthening the Minister's authority to issue directives, which undermine OEB's ability to exercise meaningful autonomy. In essence, the AG observed: "The ministerial direction-making authority has limited the OEB's ability to carry out its regulatory and oversight role on behalf of consumers with respect to renewable energy."

Other findings in the report also revealed that the absence of both transparency and accountability are in substantial measure driving up forecast increases in electricity prices—an increase of 65 per cent since 1999 and an expected rise of 46 per cent in the next five years, with 56 per cent of the increase due to investments in renewable energy because of the high cost of connecting renewable energy sources to the distribution and transmission grid.

Although the government is currently contemplating the merging of the IESO and OPA, Warren said any new structural adjustment ought to be examined through the lens of whether it enhances transparency and accountability and whether such a merger would reduce costs. A merger, without transparency and accountability in place, would only make consumers suffer.

Warren also called for banning policy directives and establishing enhanced regulatory oversight. More regulatory oversight is needed because the distribution and transmission of electricity is a "monopoly" in the classic economic sense. As a result, there exists inherent potential for abuse of monopoly power. Given that electricity is an essential service, such potential abuse of power is exacerbated by government directives affecting electricity prices and when local distribution companies' (LDCs) are viewed as centres

of profit. The Ontario Court of Appeal, in a 2010 decision, *Toronto Hydro-Electric System Limited v. Ontario Energy Board*, summarized the conflicts in the regulatory process and the role of the OEB in balancing those conflicts: “If a utility fails to operate in this way [balancing the interests of the utility’s shareholders against those of its ratepayers], it is incumbent on the OEB to intervene in order to strike this balance and protect the interests of the ratepayers.”

Warren observed that the focus of LDCs has shifted away from the protection of ratepayer interests toward maximizing the return for their shareholders. He cited the Electricity Distributors Association’s 2011 proposal for regulatory reform as illustrating the focus on enhancing shareholder return. However, the proposal was essentially silent on the obligation to protect the interests of ratepayers with respect to prices.

He also noted that complaints about the regulatory system often point to its costs, including OEB costs, LDC costs and intervenor costs. Many of these costs are, however, “churn” costs—those of complying with changing government policies and priorities. Moreover, Warren said that a cost-benefit analysis ought to be completed to shed light on those cost components. For instance, the limited data that exists suggests that intervenor costs are tiny in relation to overall LDC costs—a 2008 OEB analysis of intervenor costs for LDC rate applications found that they represented less than one-half of one per cent of the annual revenue requirement, or about \$1.50 per customer. The benefits of that \$1.50, however, are substantive, including material reductions in revenue requirements and, thus, rates, as well as increased public scrutiny of LDC costs and accompanying accountability, thereby strengthening OEB decision-making by ensuring that all affected parties are heard from.

Enabling Business-like Decision-making in Crown Utilities

The third speaker was David Hay, CIBC Managing Director and Vice Chair, World Markets, who is responsible for power and utility clients. Hay focused on governance rules that could enable business-like decision-making in Crown-owned utilities. He began with the experience of EPCOR Utilities Inc., which had been transformed from a municipal utility in Edmonton into a regional provider of water and electricity services.

Hay highlighted that EPCOR's success was largely based on governance rules that allowed the utility to run like a business. It originated from a unanimous shareholders' agreement in the mid-1990s that separated the political from the operational. All of the utility's assets and business were overseen by an arm's length professional board, mimicking a public issuer. No political appointee or official, or even a previously elected official sat on the board.

This model worked well for EPCOR, creating an organizational culture that celebrated business decision-making. As an example, the culture of business practice was reflected in the utility's decision to spin off its generation business, now known as Capital Power. The rationale was that the generation business was risky yet sustainable given the growing importance of power generation and ensuing high capital intensity and fluctuation of electricity prices. Following its divestment of Capital Power, EPCOR leveraged the consequent cash infusion by re-investing it in water utilities and electrical distribution. That diversification resulted in growth extending beyond provincial borders and even into the American southwest.

In light of the EPCOR experience, Hay pointed out that good governance rules are critically important for Crown utilities to operate more efficiently, although they should not be expected to run like a completely normal business. After all, they are owned by government. Still, Hay put forward a highly creative proposal, namely that the private sector be allowed to own 10 per cent of a Crown utility. Even such a small private sector stake would begin to transform and help re-shape the conversation at the board level. The shift in ownership structure would require the board to take into account all the shareholders' interests instead of a strict compliance with government direction. Thus shifted, the fiduciary obligation of the board does not rely on the sole obligation to government. With such a restructuring, outside counsel could also be called in to advise the board, while the government continued to maintain its influence through legislation and regulatory oversight.

This idea stimulated lively discussion. Some held that Crown utilities ought not to be expected to operate like a business, whereas others questioned the effectiveness and impact of a 10-per-cent privatization in terms of reducing political interference. Yet others viewed it as a pragmatic way to introduce the discipline of business decision-making into Crown utilities without resolving the difficult discussion associated with a 51-per-cent stake. The creative approach is to gradually bring up the level of the private sector stake within the utilities and allow the benefits of a business culture to permeate over time.

Hay also noted the success of the Canadian Pension Plan Investment Board, its governance structure and method of board appointments as an exemplary illustration of how de-politicization of public entities can be achieved. It is a model of arm's length governance and has been achieved only through effective legislation and removal of government directive authority in its day-to-day operations and decision-making

SESSION 3: MOVING FORWARD: POLITICAL CONSIDERATIONS

Session three shifted the focus to political considerations. The three panelists each provided brief opening remarks on how “good policy” proposals are often not implemented because they are not feasible when assessed against the constraints of political acceptability.

Will Stewart, a principal at public affairs company Navigator, pointed out that a consistent theme in the energy sector is politicians interfering in electricity decision-making. Short-term political considerations are almost always bad for long-term consideration of electricity policy, he said, and have negative effects on consumer and business climate.

Stewart said there will continue to be uncertainties in the governance of the sector. Until such time as individual consumers see their electricity bills in the same light that they see all other bills, they will continue to involve politicians with their electricity-related concerns. As a result, the sector will continue to experience the direct and detailed involvement of politicians in electricity decision-making. However, he added, leaving decision-making to experts and engineering is not always the right answer. There are other social factors to consider and compromises to be made besides technical solutions.

Stewart emphasized the importance and the need for key decision-makers in the electricity sector to learn how to play the game of politics in their dealings with the public and find effective ways to bridge the gaps between public perceptions and the constraints on the politicians. This would go some way in giving the politicians the confidence that the sector can manage the “sharp edges” that arise during implementation of policy initiatives. Also, this would give the politicians some latitude to back away from interfering with the sector.

StrategyCorp chairman David MacNaughton said that it is impossible to get politics out of the energy sector. And if we concede that this is so, he added, then the sector leaders need to learn how to play the game of politics better, and demonstrate that capacity to the politicians.

MacNaughton noted that different political parties have used Ontario's electricity sector for different political means. Whether it was for economic development, or for political wins or as patronage, or as an issue management tool, it was nevertheless political. That was the reason why the sector has seen so many ministerial directives.

He added that the pace and level of political interference is high and the scale of interference significant. No political party is immune from it. The depth of interference has given rise to several negative impacts in recent years. Instances abound, such as power plant cancellations in advance of an election, a failed Integrated Power System Plan, "clean" energy benefits and backtracking from those benefits, FIT reviews and amendments, and so forth.

MacNaughton suggested that the electricity sector needs to realize that one of the biggest risks regarding energy projects is politics, or regulatory risks. Therefore, a corporation should invest an equal amount of energy and resources in sound public policy advice as it would in engineering advice to figure out how to best demonstrate benefits to Ontarians who, at the end of the day, vote and influence political outcomes.

Velma McColl, a principal at Earncliffe Strategy Group, began by pointing out that no matter where you are in the country, the electricity sector is in transition—moving from a system that was built in a different time to one that is being modernized and decarbonized. "Elite" energy policy campaigns, led by experts and built around their objectives, will not be sufficient unless they are accompanied by grassroots campaigns. McColl said the formulation of energy policy and a discussion of future energy options have stopped being elite-led processes.

However, at the end of the day, she said that it is price increases to which ratepayers react and this is the one primary driver that causes politicization. The sector needs to acknowledge that both individual and corporate users regard affordable and reliable electricity as a right of citizenship and an essential service, rather than a commodity subject to market pressure.

McColl also cautioned that an emotional fear is brewing over future affordability of electricity and is exacerbated by public policy ambiguity. Thus the sector needs to better communicate to consumers and provide them with clear information on where the value-for-money proposition is.

Lively discussion followed with engagement from the audience.

One questioner asked how political decisions enter the public policy process in the United States. In response, the panel pointed out that the U.S. process is enshrined in legislation whereas the Ontario process seems to be influenced more by government directives.

One panelist emphasized that the subtext of “proper governance” was to tell politicians to get out of the way, which he viewed as improbable until the sector learns to how to play politics and properly communicate their initiative and the benefits of its policies. But as long as electricity reliability and affordability make their way onto a campaign agenda, politics will remain a salient aspect in the sector’s governance.

One audience member suggested that while the proposed 10-per-cent private ownership of utilities might bring discipline to management and add diverse voices, it would not be enough to rid Crown utilities of political influences. Besides, private business itself is a major driver in politics; thus, it could not be relied upon as a measure in achieving de-politicization.

Another observer raised the point that better governance resulting from an arm’s length structure grounded in legislation could at least hold decision-makers accountable. The audience member argued that politicians often want to look green but would avoid it if going green meant their own budgets are impacted. Thus, they announce green projects, the costs of which ultimately land on the backs of the utilities and eventually on consumers without prior conversation, blurring the line of accountability.

Finally, a member of the audience noted that consumers themselves have responsibility to reduce their own consumption instead of putting the blame on politicians for electricity price increases. Reducing consumption from end users would reduce the temperature of politics and allow room for more discussion on long-term planning.

APPENDIX 1: SUPPORTING ORGANIZATIONS

The Waterloo Institute For Sustainable Energy

www.wise.uwaterloo.ca

The Waterloo Institute for Sustainable Energy was established at the University of Waterloo in 2008 and is the focal point at the university for research in sustainable energy studies. In collaboration with utilities, private-sector partners, government agencies and civil society groups, the Institute's goal is to foster the development of innovative technologies and alternatives to existing energy production and delivery systems, and to promote energy efficiency and environmental sustainability.

Ivey Energy Policy And Management Centre, The Richard Ivey School Of Business

www.ivey.ca/energy

The Richard Ivey School of Business at The University of Western Ontario is Canada's premier business school and is recognized worldwide for the quality of its management education and research. The Ivey Energy Policy and Management Centre is the centre of expertise focused on energy business issues and public policies in Canada. Its goals are to conduct and disseminate first-class research on energy policy and to promote informed debate on public policy in the sector through supporting conferences and workshops that bring together industry, government, academia and other stakeholders in a neutral forum. The Centre draws on leading-edge research by Ivey faculty as well as by faculty within the broader University of Western Ontario community.

The Council For Clean & Reliable Electricity

www.thinkingpower.ca

The Council is a federally incorporated non-profit organization that was formed to provide a platform for open public dialogue and a solutions-oriented approach to the challenges of the energy sector. Representatives from universities, public and private sector business leaders, and strategic planning professionals have collaborated to broaden the public debate on energy issues. The Council has organized conferences on distributed generation, biomass, coal and nuclear, as well as on public sector governance in the electricity sector.

APPENDIX 2: CONFERENCE PARTICIPANTS (IN ORDER OF APPEARANCE)

Glen Wright, Chairman, Council for Clean and Reliable Electricity

Jatin Nathwani, Professor and Ontario Research Chair in Public Policy for Sustainable Energy; Executive Director, Waterloo Institute for Sustainable Energy (WISE), University of Waterloo

Jim McCarter, Auditor General of Ontario

Jan Carr, Corporate Director and Consultant

Guy Holburn, Suncor Chair in Energy Policy, Director, Ivey Energy Policy and Management Centre, Richard Ivey School of Business, University of Western Ontario

Robert Warren, Partner, Weir Foulds

David Hay, Managing Director and Vice Chair Investment Banking, CIBC World Markets

Will Stewart, Managing Principal, Navigator Limited.

David MacNaughton, Chairman, Strategy Corp.

Velma McColl, Principal, Earncliffe Strategy Group