INSTITUT C.D. HOWE INSTITUTE
Essential Policy Intelligence | Conseils indispensables sur les politiques

E-BRIEF

February 24, 2016

ENERGY AND NATURAL RESOURCES

Learning from Mistakes: Improving Governance in the Ontario Electricity Sector

by

George Vegh

- Over the last 10 years, the government has directed the expenditure of billions of dollars of public money on electricity projects with virtually no oversight or checks and balances. During this time, Ontario consumers have seen a large increase in electricity prices, with more to come.
- In response to concerns about the rising cost of electricity and poor governance, the Ontario government has touted its proposed Bill 135 as the solution. However, far from solving the concerns about electricity-sector governance, the proposed Bill entrenches and expands the status quo and provides no role for oversight of government electricity directives.
- The provincial government should move away from controlling electricity planning and instead leave the acquisition of supply to those who are responsible to meet fact-based demand requirements or, in the alternative, the government should only set broad policy objectives and not make choices on which technologies and which suppliers should receive government contracts.

2015 closed with two events that raise some fundamental issues in Ontario electricity policy: the Auditor General's Report in December; and the introduction of Bill 135 by the Ontario government in November. The two events are intimately related as they address, both explicitly and implicitly, the governance problems in the Ontario electricity sector.

The author thanks Benjamin Dachis of the C.D. Howe Institute and several anonymous reviewers for their comments on earlier drafts. He retains responsibility for any errors and for the views expressed. The author chaired an Independent Electricity System Operator process to review the role of markets: See Report of the Chair of the Market Forum (2011).

The Auditor General's Report focused on what it characterized as a planning process that has "broken down."[1] The Report noted that the government and its agencies disregarded the statutory planning process and, instead, the government directed the procurement and funding of a number of facilities and programs. These directives and expenditures were not subject to any effective checks and balances over the political decision-making of government. According to the Report, this led to a number of deficiencies, including the expenditure of billions of dollars with no cost-benefit analysis and a lack of transparency.

The cost of this lack of oversight is difficult to estimate. The Auditor General reported that directives for renewable power cost $9.2 billion more than the costs of contracts under the previous regime, which used competitive requests for proposals.[2] Other costs included paying double the price for government-selected hydro projects and paying prices 25 times higher for biomass, or plant-based, renewable energy. While there is no guarantee that a proper governance model would have prevented these costs, it would have certainly forced a review before they were incurred.

Even more fundamentally, the cost of electricity has risen dramatically and will continue to rise (Figure 1). It is remarkable that the expenditure of billions of dollars can be made with the stroke of a pen with virtually no oversight.

Electricity-sector governance is also the subject of Bill 135, which was introduced in the legislature just before the Auditor General's Report. The government responded to the Report by saying that it agreed with the Auditor General's governance recommendations and, further, that most of the problems will be improved by the passage of Bill 135.[3]

However, far from improving the governance of the sector, Bill 135 entrenches and extends the main failings identified by the Auditor General. It therefore threatens to make the problematic status quo into a permanent state.

In this E-Brief, I review the state of electricity-sector governance and propose the following recommendations to improve it.

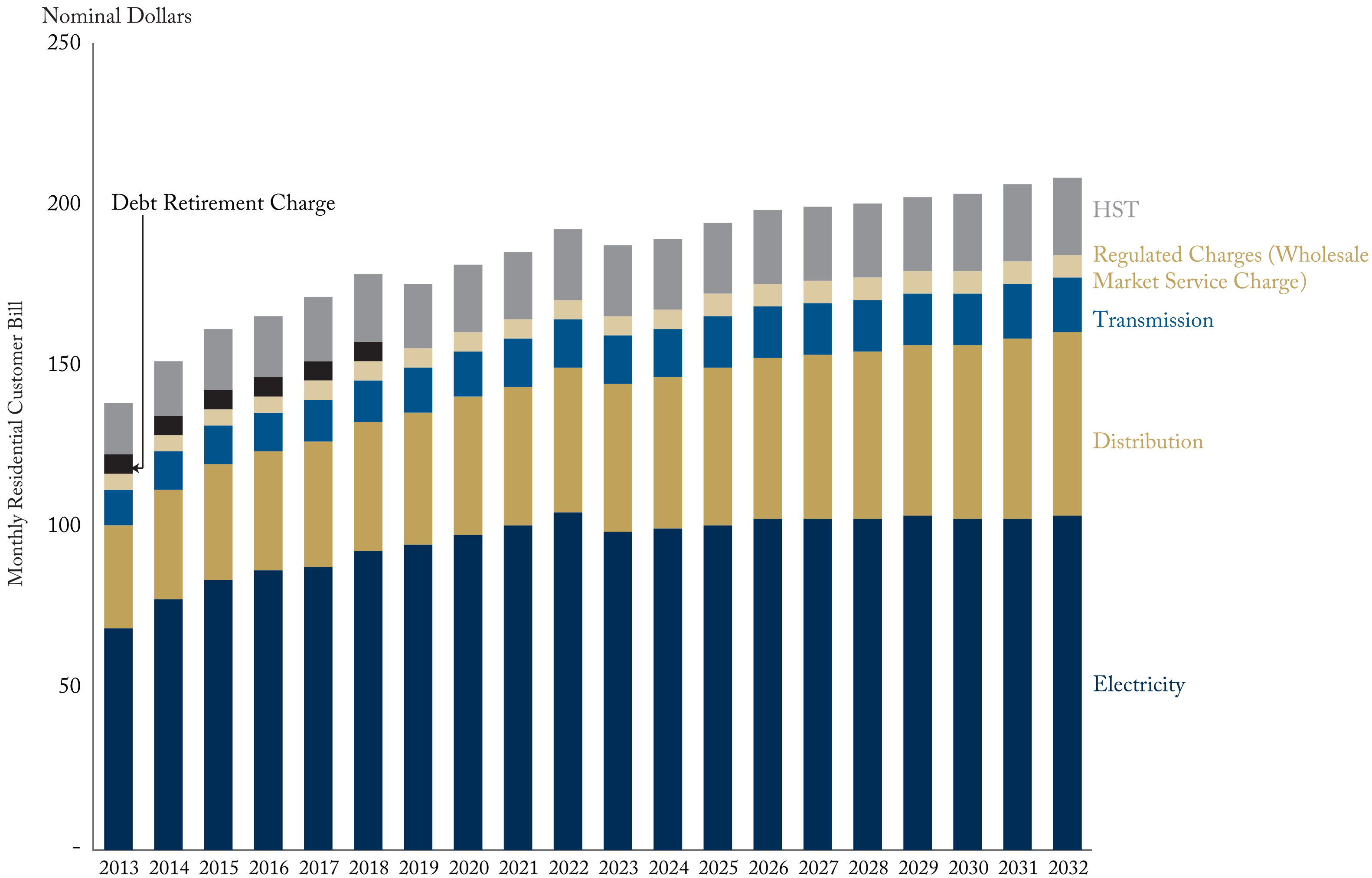
1. Move away from a central planning model towards a locally based supply and operational obligation that aligns accountability with responsibility.
2. Even if the government is to maintain its central role in setting outcomes, it can reduce its role in picking winners and losers. This requires increased reliance on market mechanisms, including requests for

1 Auditor General, 2015 Annual Report, p. 217.

2 Auditor General, 2015 Annual Report, p. 214. A number of commentators (Butters 2015, Huggard 2015, Nathwani 2015, and Regg Cohn 2016) have raised issues with the Auditor General's treatment of costs. They argue that the Auditor General overstated cost concerns because she treated all of the costs of Global Adjustment as over spending on supply and conservation (approximately $37 billion). According to the critics this demonstrates that the Auditor General does not understand how electricity costs and prices operate. However, the Auditor General did not make this claim. The Report does not state that all of the costs of Global Adjustment represent overspending. The overspending was with respect to specific transactions, including those cited in the text. If nothing else, the widespread confusion over costs and how they relate to price should support the case for greater cost transparency and accountability than is now currently the case.

3 Auditor General, 2015 Annual Report, p. 219.

Figure 1: Typical Residential Electricity Bill Forecast – Before Ontario Clean Energy Benefit



Notes:
Based on Toronto Hydro's 2012 annual average residential bill, assuming 800 KWh/month.
Inflation rate 2% assumed to convert real 2012 dollars to nominal dollars.

Source: Ontario Power Authority.

proposals (RFPs) and capacity markets to meet operational and capacity needs based on demonstrable system requirements.[4]

Before discussing the limitations of Bill 135 in detail, it is helpful to step back and consider why good governance in the electricity sector is particularly important.

Electricity Sector Governance

Good governance has been the subject of endless debates. For simplification purposes, the International Monetary Fund has described it as "ensuring the rule of law [and] improving the efficiency and accountability of the public sector."[5] The rule of law supports a rule-based system – one with constraints on the government's exercise of discretionary decision-making. Efficiency and accountability involve an alignment of accountability with responsibility. In the electricity sector, this would put accountability for meeting electricity requirements into institutions that are responsible to meet them.

Virtually every North American jurisdiction outside of Ontario puts this responsibility into so-called load-serving entities, such as local utilities. In Ontario, this role is taken on by the provincial government.

The Auditor General's Report found a departure from the principles of good governance. The government and the relevant agencies put virtually all electricity decision-making into the hands of the government which, not surprisingly, used these powers to design an electricity system that reflected more of a political consensus than electricity demand requirements.

The consequences of poor governance in the electricity sector included overspending on supply, both by paying above market rates and by purchasing more supply than required to meet system needs. This led to both expensive electricity prices and a distortion of societal public spending on infrastructure. Because the government does face governance constraints when spending taxpayer money (the budget process, legislative change, the financial oversight of the legislature and lenders), but faces virtually no constraints when spending electricity ratepayer money, it is more likely to spend the latter. However, the economy has finite resources available to pay for infrastructure. If a disproportionately large amount is dedicated to unnecessary electricity projects, then that amount is not available to meet other needs – such as transportation, schools and hospitals. The province has therefore had to turn to other sources of financing to cover those costs.

Finally, and perhaps most importantly, good governance furthers democracy by imposing checks and balances on the exercise of governmental power. By its nature, it is meant to create constraints to ensure that public powers are used to benefit the public interest, as opposed to "corruption, clientelism, favouritism, patronage, nepotism, or undue support to a special interest groups."[6]

Ontario is lucky in that explicit corruption and bribing of politicians is not part of our history or culture. It would benefit the government, in pursuing the goal of superior delivery of an important service at the lowest cost

4 Capacity markets or capacity auctions permit generators and demand response providers to bid to meet capacity requirements with the result that the market can produce separate prices for energy and capacity. See Goulding (2013) and Wyman (2014) for details.

5 International Monetary Fund, cited in *The Oxford Handbook of Governance* (2012).

6 Rothstein in *The Oxford Handbook of Governance* (2012, 151-152).

possible, to adopt and be seen as adopting models that do not leave the door open to clientelism, favouritism and undue support of special interest groups.

To be sure, developing and following objective criteria takes longer than issuing a government directive. Indeed, the Ministry of Energy responded to the governance criticism by advising the Auditor General that it had by-passed the planning model because it found that process to be "expensive, lengthy and inflexible."[7] However, an intentional design characteristic of a governance model is to provide constraints and be somewhat lengthy and inflexible by design, but also allow for innovation and instil public confidence in the review process. One of the major problems with the feed-in-tariff model[8] of procuring power was that it was imposed in a rush, without time for proper deliberation on its costs and benefits.

The government agreed with the Auditor General's critique of the "break down" of the planning process. However, it explained that Bill 135 would improve the process by "clarifying" the respective roles of the government and the Independent Electricity System Operator (IESO) and by imposing a statutory consultation requirement on government plans.[9]

It is therefore worth examining the governance model under Bill 135. Specifically, what are the criteria that Bill 135 applies to the exercise of governmental power in the electricity sector? The short answer is that there are none.

The Shortcomings of Bill 135

The Auditor General's Report detailed the governance problems in the sector, including: lack of independent oversight, lack of transparency in decision-making, and leaving the government as the sole decision-maker in electricity planning and procurement.

Bill 135 does not address any of these problems. Instead, it entrenches and extends them. It provides that the government shall prepare long-term energy plans for electricity and natural gas.[10] Apart from requiring the IESO to prepare a report on adequacy and reliability prior to government planning, the plan removes the role of the IESO and the Ontario Energy Board (OEB) in development and review.[11] The OEB's current role is to review the procurement processes and the Integrated Power System Plan to see if it is "economically prudent and cost effective." Bill 135 will remove these powers.

Further, under Bill 135, the government's long-term energy plans have a broader scope than the bulk system plans that the IESO was charged with developing. The bulk system is restricted to the IESO administered market. Therefore, the IESO's planning role is to be restricted to transmission. Its procurement role is now restricted to generation and conservation. Bill 135 extends the government's planning power to the distribution level (which

7 Auditor General Report (2015, 217).

8 A feed-in-tariff provides electricity generators a fixed amount for every unit of electricity they produce, regardless of the market value of electricity.

9 The IESO implements the government's electricity procurements and operates the electricity grid.

10 Bill 135, s. 7.

11 The OEB determines utility rates, service and connection requirements.

the OEB has always regulated) and the government's procurement authority would extend beyond electricity supply to electricity transmission (which the OEB has also always regulated).

The OEB and the IESO are reduced to (i) preparing plans (for government approval) aimed at implementing the government's plan, and (ii) using their statutory powers (to plan and procure assets, etc.) for the purpose of implementing that plan.

Bill 135 thus both entrenches and extends the government planning process, which was the centre of the Auditor General's critique. It leaves the electricity system with even less oversight of government decision-making than is currently the case; there are no meaningful criteria respecting the expenditure or money and no checks and balances with regard to how that money was actually spent.

This calls for an alternative model.

An Alternative Governance Model

Bill 135 provides no statutory provisions for electricity policy governance. This is unfortunate and it should be amended to include some recognition of good governance principles, including the following:

1. Move away from a central planning model towards a locally based supply obligation that aligns accountability with responsibility.

One of the fundamental problems with Ontario's electricity practice is that virtually all electricity decisions have been centralized into the provincial government. While it is entirely appropriate for political decision-makers to establish the goals of electricity policy, Ontario went well beyond that.[12] It chooses the technologies and companies that it believes are best suited to meet the needs of the province. Because it is ultimately a political actor, its decisions not surprisingly reflect more of a political consensus than the actual demand requirements of consumers.

Most jurisdictions in North America do not use central planning – let alone governments – to identify and implement resource needs. Rather, they use the more simple mechanism of imposing the obligation on local load-serving entities to meet the supply obligations in their regions. These obligations consist of requirements relating to reliability, cost and environmental impact. The achievement of these requirements is reviewed by a public utility regulator, like the OEB.

The government can instead require load-serving entities to demonstrate how they went about sourcing resources to cost-effectively meet their supply obligations. They can thus be held accountable to meet their obligations in a way that the government and the IESO cannot be. This method can therefore align responsibility and accountability more effectively than putting procurement decisions in the hands of the provincial government.

12 A useful comparison to the technological- and company-specific Ontario government directives are the broader policy goals that are set by the United Kingdom government to require its agencies to meet social and environmental policies but leaving the choice of technologies and actors to a more open and transparent process to be run independently by energy and gas agencies. See: Social and Environmental Guidance to the Gas and Electricity Markets presented to United Kingdom Parliament pursuant to section 4AB(4) of the *Gas Act 1986* and section 3B(4) of the *Electricity Act 1989*.

2. Increase reliance on market mechanisms, including RFPs and capacity markets to meet needs based on demonstrable demand requirements.

Recognizing that the government should continue to set the goals of energy policy, there are many different means available to achieve them in an efficient and cost effective way. Reliance on transparent and robust markets is a form of governance in the sense that they provide mechanisms to restrict the exercise of discretionary power. The IESO has been addressing the importance of market mechanisms. In order for markets to perform this function, they will require independence from government decision-making. Given Ontario's history, it is naive to proceed on the assumption that governance will somehow "take care of itself" without transparent and meaningful oversight of the IESO to keep the government at arms-length and not dictating market outcomes.

For example, American Independent System Operators, who have the same function of the IESO, are subject to oversight by the Federal Energy Regulatory Commission. Its role is to ensure that the markets they establish and operate are fair and non-discriminatory. The OEB could perform a similar function in Ontario.

Conclusion

The Auditor General's Report shed light on governance problems in Ontario's electricity sector. Bill 135 should provide the occasion to correct those problems. Unfortunately, as drafted, it threatens to entrench and extend them.

References

Auditor General of Ontario. 2015. "Annual Report 2015." December.

Butters, David. 2016. "The truth about the price of electricity." *Toronto Star*. December 15.

Department of Energy and Climate Change. "Social and Environmental Guidance to the Gas and Electricity Markets presented to United Kingdom Parliament." United Kingdom. Accessed at: https://www.ofgem.gov.uk/sites/default/files/docs/2007/05/file37517_2.pdf.

Goulding, A.J. 2013. *A New Blueprint for Ontario's Electricity System*. Commentary 389. Toronto: C.D. Howe Institute. September.

Huggard, Bob. 2015. "The Auditor-General left consumers in the dark about Ontario's electricity upgrade." *Globe and Mail*. December 25.

International Monetary Fund, 2005. "The IMF's Approach to Promoting Good Governance and Combating Corruption: A Guide (2005)," quoted in Bo Rothstein, "Good Governance" in David Levi-Faur (ed.), *The Oxford Handbook of Governance* (Oxford, 2012).

Nathwani, Jatin. 2015. "Auditor-General offers incomplete picture of Ontario's power upgrade." *Globe and Mail*. December 10.

Regg Cohn, Martin. 2016. "Fun with numbers on your monthly hydro bill." *Toronto Star*. January 10.

Vegh, George. 2011. "Reconnecting Supply and Demand: How Improving Electricity Pricing Can Help Integrate a Changing Supply Mix, Increase Efficiency, and Empower Customers: Report of the Chair of the Electricity Market Forum." December.

Wyman, Michael. 2014. "Rethinking Ontario's Electricity System with Consumers in Mind." E-Brief 182. Toronto: C.D. Howe Institute. September.

This E-Brief is a publication of the C.D. Howe Institute.

George Vegh practices energy regulation at McCarthy Tétrault and teaches regulatory policy at the University of Toronto School of Public Policy and Governance and energy law at University of Toronto Law School and Osgoode Hall Law School. He is the former General Counsel at the Ontario Energy Board.

This E-Brief is available at www.cdhowe.org.