

**Competitive and deregulation in electricity:
the national and continental dimension**

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Mr. Garant has been involved in the North American energy sector for the last 10 years. He worked 6 years in the investment community, specializing in financing equity investments in oil and gas exploration and production companies and energy distribution companies.

Mr. Garant joined Hydro-Québec in March 1997 as Director – Project Development, and was appointed Managing Director – Wholesale Markets and Project Development in November 1999. In this capacity, he has direct responsibility for wholesale markets – energy transactions for markets outside Quebec – and power generation development projects.

Mr. Garant holds a business degree (Université Laval, 1989) and is a Chartered Financial Analyst (Association for Investment Management and Research, 1994).

Plugging in Atlantic Canada

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Presented by

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This is a very interesting time in our business. How many people in this audience would have predicted – 3 years ago – that the home market of Hydro-Québec, would be moving towards a deregulated, competitive market for the supply of electricity. Who would have predicted this. How many of those people would have also bet on current natural gas or crude prices. This shows at least two things : the extent of the changes sweeping our industry, and two : predicting the future continues to be a risky proposition. I'll try to limit my own predictions here today. So let me report now on recent developments in Quebec and with Hydro-Québec.

The generation of electricity and wholesale supply of electricity in Quebec will now be a deregulated business based on the gradual introduction of a competitive, contested market at the wholesale level. This is the result of legislation passed by the Quebec National Assembly this past June. Basically, our understanding is that government decided to deal with the main issue associated with deregulation, the question of HQ's market power in generation – 36 000 MW of it – through a vested contract mechanism. They have mitigated our market power by legislating a long term fixed price supply contract between HQ's generation and distribution groups – operating as functionally separate divisions within corporate HQ.

This – in essence – is a “vested contract” in favour of consumers, it commits the bulk of our current generation portfolio to the Quebec distribution market. At a fixed price of about 2.8¢/kWh. The size of the contract is up to 165 TWh, that's 4.6 B\$ of wholesale electricity. We can currently produce and sell in a normal year a little over 170 TWh, after line losses. So basically, HQ is almost fully contracted for its current generation and supply contracts with the growing Quebec market. This year for example we expect the Quebec distribution grid to pull a little over 150 TWh on this contract. And this will evolve over time on the strength of the local economy.

Beyond the “vested contract” it's an open game. The distributor will put up for tenders all new capacity and energy requirements approved by its regulator. They'll get a supply plan approved and they'll execute on it. HQ – Generation will be able to participate in these tenders – we will remain a player. But we certainly expect to see a good level of competition. And this is good. It's good for consumers, it's also good for HQ's Generation Group. Competition will test our abilities and imagination. Competition may arrive in a very strong way or it may proceed in a more gradual and cautious way – at this stage no one can be sure, the market will decide.

We will keep the franchise rights to develop large scale hydro in Quebec – a challenging, but interesting business as you may know. The potential for this remains quite significant. On this let me restate our policy. We will develop all large scale hydro which meets the test of the following 3 conditions :

- ™ Economic viability in a competitive and very volatile commodity pricing environment, going forward.
- ™ Environmental soundness – for which HQ has a world class track record. You're all invited to see it with your own eyes – we're very proud of this record. And we're continuing to improve. Hydro is, along with nuclear and others, part of the solution to the Greenhouse Gas effect.
- ™ Our 3rd condition is local acceptability of hydro projects – demonstrated through partnerships built around the concept of resource revenue sharing. This last condition involves both our local municipal partners and our First Nation partners. The Betsiamites and Toulousteuc projects – 700 M\$ of investment in projects which will produce over 3 TWh/year – signed by HQ last year proves that this is possible.

With large scale hydro, we will take our time. We will do it right. We think it's good business to approach it this way.

Will HQ – Generation do more in terms of new generation than just large scale hydro in Quebec? The answer is yes, but in a very selective way.

We look to move cautiously beyond our large scale hydro niche, in areas where things are by definition a little more generic. Cautiously, because this is becoming a pretty pure commodity pricing environment. Which means, if history and other commodities are a lesson, that value is going to cycle often and sometimes unexpectedly from one end of the value chain to the other.

So you can expect to see HQ in new areas of generation. We like windpower if it's competitive, we like distributed generation but there's natural gas supply and prices to deal with. In this area, Hydro-Québec has invested in Captstone, a microturbine manufacturer – they've done a fantastic job and perspectives are excellent.

In terms of the opening of Ontario's market, let me first say that we appreciate the complexity of what is going on there and we have a lot of respect for actions taken so far. We understand that delays will occur, as they have. Having said that, it's difficult to predict the impact of Ontario's opening on our export business. Our strategy will depend on regulation and prices in the Ontario market.

In terms of the market in Atlantic Canada, HQ has developed and maintains a long standing commercial relationship with New Brunswick Power and has recently expanded its commercial activities in the Atlantic Region.

Generally, we think we can play a role here in Atlantic Canada by trading and moving off-peak and on-peak energy back and forth, for example, using the storage capacity of our large hydro reservoirs. We think this can be a win-win situation for HQ and consumers in this market. Of course, in line with this strategy, we will maintain a presence and follow closely the development of the market and the evolution of the regulation and functioning of the Canadian Atlantic market.

Looking at our wholesale marketing and trading activity in 2000 with competitive US markets, this has been a roller coaster year. Tremendous volatility. That to me is the biggest factor. We knew it would be a volatile pricing environment – it's been that and more. You've all heard the numbers – and now we have the run-up in gas prices and oil which is placing additional pressure on the system for the coming winter – our own domestic peak consumption period.

HQ has participated in the US market in a growing way in 2000. You'll notice it in our year end top line revenue numbers – and hopefully in our bottom line. We see this business contributing in a significant way to our growth in the coming years. But, it's a very competitive environment and there are other very good players out there. At this stage, HQ is certainly not a top tier player in wholesale trading in the Northeast, but we're committed and growing.

I'd like to say a few words also on a related matter. We've all heard about California power markets this summer. I'm not an expert on California, maybe that market is not working, and maybe it is. I know one thing : if you can't build transmission – and let me tell you we have some experience in this, – if permitting new generation or even relicensing old, including small hydro, continues to get longer, harder and more expensive, and demand continues to grow the way it has over the last few years, it's pretty clear what will happen – anywhere. Let's talk about all the issues : including permitting processes, siting, in general, and the proper financial rewarding of the very very difficult business of developing linear projects like gas and electric transmission. In the meantime, as an industry, let's not forget that the new market structure only started last year in some cases (New York, for example), and the complexity of what has developed is huge – in terms of information systems for example. If the regulated utility rate base machines had evolved at the pace we've seen markets develop in the last few years, I'm not sure we would have had deregulation. So my personal view is that it's too early to draw conclusions. Perhaps we need to let this thing unfold a little longer.