Financial Aspects of Competition and Deregulation in Electricity

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AIMS/ECANS Conference – October 27, 2000
Plugging in Atlantic Canada

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Comments on Deregulation / Re-regulation

Consumers in Canada are supportive of the concept of deregulation, since it promises to encourage competition. Competition almost invariably results in greater uncertainty, higher volatility in prices, greater concern about security of supply, BUT lower prices to consumers, at least on average and over time.

Investors in Canada are supportive of deregulation because it offers heightened volatility, which stimulates market activity. It also promises to encourage privatization of Crown-owned utilities (see below) which will add to the supply of shares available to investors.

The logic of separating generation and retail activities from transmission and distribution activities, based upon their divergent risk characteristics, is compelling. We are fortunate to have examples of this process attempted in other jurisdictions, about many of which we heard this morning. At least in North America, however, the results of deregulation so far have been extremely disappointing.

Many people, including our firm, who think about the possible benefits of electricity deregulation draw a parallel with the telephone business restructuring that has taken place over the past decade. Telecom competition led to significant change, moving us from highly centralised control to cell phones and the Internet. A similar shift is starting in electricity, with new competition from smaller and cleaner technologies. The Promised Land will have lower prices for consumers and more capacity, located right at the point of demand.

So-called micropower is tantalising, and close, but unfortunately it is not here - yet. No ‘magic bullet’ technology, one that alters the economic parameters enough to support new players, is in the market. And that is the central problem with deregulation in small regions such as Atlantic Canada.

When jurisdictions open up competition in generation, they implicitly assume that there are numerous investors who are standing at the door waiting for it to open. In large markets such as California and Ontario, that can be true, with ‘new-old’ technologies such as gas turbines available to be deployed. But the reality is that even in these jurisdictions competition against incumbent suppliers remains daunting. In smaller regions, true generation competition must await the development of commercial, competitive ‘new’ technologies – fuel cells and the like – before meaningful progress can be made.

This is not to say that we in Atlantic Canada shouldn’t open up generation for competition – I believe we should. But let’s not set unrealistic expectations around it. It is highly likely that nothing major will happen for several years.

In my view, the cost of deregulation initiatives, and the risks of implementing changes badly, should weigh heavily on policy makers in Atlantic Canada as they deliberate on the future. Perhaps a better target for the immediate future in this region is to shift to a regional Maritime electricity market, and then move on to selective regulatory changes.

Thinking of these issues led me to consider what might constitute a formula for a successful re-regulation process:

- Establish regulator independence from the industry
- Adopt a regional perspective
- Think across energy sources, not just about electricity
- Define business segments that are independently viable, without subsidies or government protection
- Change the regulation structure only on those segments that can sustain clear, transparent and meaningful competition
- Further out, institute an industry owned and operated oversight function, accountable to the regulator

Privatisation

To capture the benefits of deregulation and avoid the pitfalls, the first criteria mentioned was independence of the regulator. This goal simply cannot be achieved if there is cross ownership of the business being restructured and the regulator.

In Ontario, for example, the Province is trying to capture the benefits of competition in the electricity sector, but it owns virtually the entire business. Any moves to press Ontario Power Generation towards competition, for example, directly impacts on the value of OPG, which they own. To be kind, one can say that this complicates matters.

Enter privatisation. A bad word in various jurisdictions at various times, it represents a transfer of economic power from government departments to the private sector, where profitability is the focus.

The most effective argument mounted by critics of privatisation is the loss of control of essential services. This resonates with the public – you mean my lights may not go on? – and prompts politicians to balk at overriding their officials’ opposition to the concept. And yet investor-owned utilities exist all over the world, are managed well and are regulated effectively to ensure that the public good is served.

The role of government, in my view, is to channel profit-motivated behaviour towards socially desirable outcomes, not to own everything.

And does it work? A clear answer resides right here in Nova Scotia. NSPI was privatised in 1992, and stands out as a progressive participant in the industry ever since. Consumer rates have not been changed since 1996 – except for reductions requested by the utility. Risks are being managed aggressively to avoid unpleasant surprises – of course to protect investor returns but also to protect their customers.

The Province continues to oversee the utility's activity, to regulate its rates to consumers and to impose restrictions on business activities that affect the community.

Impact on Provincial Finances

Being a finance guy, I cannot pass up the opportunity to bandy about some numbers. First, the topic of Crown owned utilities in Canada is no small matter. Nova Scotia Power was sold to investors for $850 million, plus $1.5 billion in net assumed debt. That debt was guaranteed by the Province of Nova Scotia, and represented about ½ of the total credit exposure of the Province.

Selling Crown-owned utilities can be very beneficial to the financial condition of the government, both from the immediate cash inflow and from the relief of the guarantee. The economic benefit of having a non-taxable business transformed into a fully taxed business does wonders for the treasury. Offering local investors the opportunity to earn profits from their local utility has numerous positive effects. Finally, a healthy and growing business that supports commerce in the region by providing reliable energy just has to be good.

Investor-owned *vs*. Crowns

So is the Private Sector the panacea for all ills? Obviously no. Investor owned utilities are usually well motivated to consider the issues and make sensible decisions, without the overlay of political bosses. But they still make mistakes. Some managers are timid in the face of great opportunity. Some managers are bold in the face of excessive risk. Service levels are sometimes no better than their Crown-owned peers.

What makes the real difference is that the result of investor-owned business decisions is not dumped directly on the taxpayers, who have no say in the process, but on shareholders, who have a more direct stake.

Which comes first?

My final comment before questions is on scheduling. Privatisation of Crown-owned electric utilities must be done first, before any meaningful moves towards competition are introduced. If a jurisdiction determines to retain government ownership of a business, there can be no effective deregulation. It matters.

Privatisation of the Crown-owned electric utilities across Canada is the most effective way of supporting initiatives to encourage competition.

Once again, the examples are right here in Canada. In Ontario, the government has attempted to mix the two efforts together, and the results are chaotic. To describe the process as ‘deregulation’ is to make light of that word’s traditional meaning. Industry is confused by the sudden policy shifts that have been made. The Province is frustrated by the complexity of the process, the special interests groups and by the narrow path it must walk between stranded debt recovery vs. wide-open competition for new generation.

Alberta, and in many ways California as well, has a whole different set of problems. The Government was not confused by its own ownership interests, and (at least to some observers) was thus left to make a hash of the effort for other reasons. I would argue that the criteria listed earlier for successful deregulation were not met in those cases, and the initiatives stumbled.

We in Atlantic Canada have the benefit of watching trail blazers in other jurisdictions, and then inviting speakers from around the world to share their experiences. Let’s listen.

Thank you