

BACKGROUND TO ONTARIO'S IMPENDING ELECTRICITY MARKET OPENING

The Ontario electricity industry has undergone radical restructuring in preparation for May 1, 2002, the target date for market opening and the start of Ontario's transition to fully competitive prices.

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A Short History of Events:

Ontario was set on the path towards electricity deregulation in May 1996 with the release of the White Paper on competition in *Ontario's Electricity System: A Framework for Competition*. Emphasizing affordable electricity rates, provincial competitiveness, financial soundness, and quality of life, the paper recommended a phased process towards a competitive electricity system. The passing of the *Energy Competition Act, 1998* (the "Act") confirmed that a competitive electricity market would eventually be a reality.

The Market Design Committee, established in January, 1998, provided advice on market rules and the structure of the competitive electricity market to be created under the Act. The Act has required massive restructuring of the electricity industry. Among the necessary activities were: the separation of the provincially-owned, vertically integrated monopoly generator and transmitter that was Ontario Hydro; the introduction of the Independent Market Operator; the incorporation of the municipal electricity utilities

as distribution companies with their municipalities as shareholders; and a new regulatory framework.

The distributors in particular were faced with a plethora of required changes. This sector underwent substantial reorganization with mergers, amalgamations and divestitures in 2000 and 2001 resulting in a drop in their numbers from in excess of 240 to 94. These distribution companies, which had previously operated on a not-for-profit basis, must now run their businesses as corporate entities with shareholders that expect to receive dividends. Further, they were required to restructure their rates and implement unbundled rates and were responsible for setting up retail settlement systems. For some distributors, this involved the installation of new billing and customer information systems. Metering requirements related to settlement also had to be met before market opening.

The new regulatory framework involved the development of licensing codes, the licensing of all industry participants, and the regulatory approval of rate schedules for the monopoly components of the industry that reflect the new market design and introduce unbundled rates. All of these activities took place in the context of an industry over which the OEB had had no regulatory authority in the past.

A Synopsis of Market Design

The Participants - The electricity market participants are:

- the generators,
- the transmitters,
- the distributors,
- the retailers, and
- the wholesalers,

The Independent Market Operator (the “IMO”) administers the wholesale market while the Ontario Energy Board (the “OEB”) is responsible for regulatory oversight of the industry.

Rules and Codes - Among the sets of rules and codes that are in place are;

- A code which governs affiliate relationships,

- A code of conduct for electricity retailers,
- A code for Standard Supply Service
- Rules to ensure open access,
- A code which governs retail settlements,
- Rules for the administration of the IMO market, and
- A code that ensures the integrity of the network systems

Supply and Retail Arrangements: Retailers and large volume customers can either purchase directly from generators, which is a bi-lateral transaction or from the IMO administered market. Retailers then sell electricity in the retail market generally through multi-year fixed term contracts to small industrial, commercial and residential consumers. Distributors purchase electricity from the IMO at the hourly spot market price and supply customers in their respective service areas who choose not to buy from a retailer, either at a forecast average hourly spot market price set by the OEB or, if they have obtained the necessary exemption from the OEB, at the average actual spot price over the billing period.

While the OEB has control over the terms and conditions of retailer contracts, it does not regulate the electricity prices that generators and retailers charge. Retailers procure electricity supply for their customers through various options available to them. As such they may have a supply portfolio that includes fixed price contracts with generators, hedging instruments, and market purchases. Retailers offer customers fixed term contracts that ensure the customer a given price over the term of the contract with some retailers offering contracts up to a maximum term of five years.

Standard Supply Service (SSS) - Distributors do not provide competitive retail service, but, in addition to being responsible for electricity distribution, they are obliged to provide SSS to customers who do not choose to buy from a retailer. The distributors will obtain SSS at the IMO's spot market price. The spot market price reflects, and fluctuates with, changes in the demand for and supply of electricity at a given time. They will in turn charge their SSS customers either at the same price, if they have been granted an exemption by the OEB, or, if no exemption

exists, at reference price set by the OEB. A change in the SSS reference price charged by distributors is triggered by a change in the spot price of certain magnitude. Therefore, customers who remain SSS with a distribution company charging the SSS reference price may also be subject to price fluctuations as well as retroactive bill adjustments to collect shortfalls or refund over-collections.

Market Power Mitigation - Currently, Ontario Power Generation Inc. (“OPGI”) owns a large majority of the generation in Ontario and there is limited capacity for inter-jurisdictional activity. This results in OPGI having a significant level of potential market power. Customers on SSS are subject to the spot market price and are therefore vulnerable to the impact of this market power. To mitigate the impact of OPGI’s market power, a Market Power Mitigation Rebate will be forthcoming to those who obtain supply through the IMO administered market, including customers on SSS, if the annual average spot market prices are above a formulaically derived tolerance level.

Getting Market Ready

While market opening was originally targeted for November 2001, there was uncertainty as to the industry participants’ state of preparedness, and a lack of coordination of activities that would ensure the successful end-to-end market system integration by that date. As a result the Government postponed the market opening market date

The OEB, understanding the need for a coordinated effort to achieve market readiness and having the authority to require distributors’ market readiness, took on the responsibility of coordinating electricity retail market readiness. Working with the IMO and a stakeholder task force, a market readiness plan was put in place that set out a schedule for market readiness and was based on a simultaneous opening of the IMO administered market and the retail market.

In October of 2001 the Government announced an anticipated market opening date of May 1, 2002.

Through the OEB market readiness self-certification process 71 distributors, servicing 95% of the approximately 858,000 customers in Ontario who have signed up with a retailer, indicate that they anticipate being ready to provide retail settlement services on May 1. Further, market design tests conducted in the last month have indicated end-to-end market system readiness. Customer readiness is of utmost importance in achieving a healthy competitive market and significant customer education programs have been implemented.

The Pre-Market Opening Environment

While it appears to be “All Systems Go” for a May 1, 2002 market opening, past events in some other jurisdictions have caused some pockets of concern to remain.

The 2000-2001 electricity price spikes experienced in California and in Alberta have made some parties wary of the market opening in Ontario. While the Government takes the position that conditions in Ontario upon market opening are expected to result in lower electricity prices in the long term, some parties are not persuaded and believe that like any market, there will be unanticipated events that could result in price shocks that raise questions about the benefits of competition. It may be wise to acknowledge that market dynamics are less controllable than a regulated monopoly, especially in the short run. While costs on average may decline in the long-run, price volatility is likely to increase, making hedging an important ingredient in meeting consumers needs.

Customers have already experienced increases in rates in the pre-market opening period, as a result of the increased returns earned by distributors upon incorporation,

the introduction of proxy taxes and a debt reduction surcharge being collected to pay off the former Ontario Hydro's debt.

What Happens When the Market Opens

With approximately 4 million electricity customers in the Province, the OEB's estimate of 858,000 retail sign ups suggests a penetration rate of about 21% for a May 1, 2002 market opening, which is a good start towards retail competition.

However, in recent months tactics used by some retail agents have resulted in a rash of severe public criticism of retailers. The publicity relating to these concerns may slow the rate of retail penetration as consumers who have not signed up for retail supply, hearing the message of "buyer beware", stay clear of any retail arrangements. Since a fixed-price contract with a retailer provides consumers protection against price fluctuation, diminished retail penetration will expose a larger number of consumers to the potential of price fluctuation in the short term.

Of course with OPGI's Market Power Mitigation Rebate, consumers on SSS will be protected from the full impact of price increases above the established threshold. As such, Ontario's market opening on May 1, 2002 is, perhaps, in reality a transitional market opening with the length of the transition period dependent on the period of time over which the rebate is phased out. This in turn will depend on the rate at which OPGI divests its assets to abate its market power, and is in the control of its shareholder, the Province.

Further, there is limited inter-tie capacity with neighbouring jurisdictions and therefore the potential to buy and sell electricity outside of the province is limited. This limitation, in addition to Government control over OPGI, will work to mitigate the full impact of competitive forces. This should give some comfort to those that are wary of the impending electricity market opening in Ontario and lead to a less dramatic market opening than in California and Alberta.

CERISE will continue to monitor this process and will provide additional articles as matters develop.

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