

Electricity Competition Act: Implications for Water Utilities

a report prepared for the

Ontario Municipal Water Association

prepared by

Neil B. Freeman, PhD
Public Policy Consultant

ONTARIO MUNICIPAL WATER ASSOCIATION



Who are we?

- The Ontario Municipal Water Association (OMWA) is an association of elected and appointed officials representing the municipal public water authorities in Ontario.
- OMWA speaks for municipal water authorities and customers on legislative and regulatory matters related to the treatment and supply of drinking water in Ontario.
- OMWA has a wide cross-section of knowledgeable representatives from the water authorities who provide direction and leadership on policy issues for the association.
- OMWA works with the Ontario Water Works Association (OWWA) – the local professional association of the American Water Works Association – on issues of mutual concern and interest.

What are our objectives?

- OMWA works to develop and maintain the best possible quality, reliability and safety of the drinking water supply in Ontario.
- OMWA works to initiate policies related to standards of equipment, operations, and general management that are in the best interests of municipal water treatment and supply.
- OMWA works to obtain uniform policies for rates, accounting, and operations for all provincial and municipal water supplies.
- OMWA works to improve municipal water treatment and supplies in co-operation with the Ontario government and with other water authorities.

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Contents

1. General Introduction and Overview	3
2. Water & the Conversion of MEUs to Share Ownership Utilities	5
2.1 The Framework for Share Ownership MEUs.....	5
2.2 Implications of Share Ownership for Water Utilities.....	6
3. Water & the Merger of MEUs across Municipal Boundaries	9
3.1 Framework for Mergers of MEUs	9
3.2 Implications of Mergers for Water Systems.....	11
4. Water & Impact of Share and Merged MEUs on Local Control.....	13
4.1 The Framework of Local Control of Water Utilities.....	13
4.2 Implications for Local Control of Water Utilities	14
5. Options for Structuring Water Governance and Operation.....	17

1. General Introduction and Overview

Key Findings:

- the *Electricity Competition Act* gives municipalities new private sector-like foundations and objectives for their MEUs; these either may not be suitable for water utilities or may, in turn, have the effect of changing their business and customer service objectives
- the legislation has the potential to change the manner in which water is provided, possibly even more so than the amendments to and the proposed redrafting of the *Municipal Act*
- the municipal initiatives only have implications for the governance of water utilities; the electricity initiative can affect the management of the water systems, and, indirectly, the ownership
- the changes to MEU have broad implications for all Ontario's water utilities, but have their most immediate impact on PUCs that operate both water and electricity
- municipalities have four options: run the water directly; use re-created MEUs to run them on behalf of the municipalities; contract the water system to alternative service delivery providers; keep or create a public utility commissions

Analysis:

With the *Electricity Competition Act* having recently received passage on October 30, 1998, the time is now right for OMWA members to examine the impact of this legislation on their water utilities. The reason this is so necessary is that the electricity legislation gives municipalities new private sector-like foundations and objectives for their municipal electric utilities (MEUs). These either may not be suitable for water utilities or may, in turn, have the effect of changing the water utilities' business and customer service objectives.

On first appearances, the *Electricity Competition Act* seems to have a benign or non-existent affect for most municipalities' water systems. A closer examination of the possible implications, however, suggests this conclusion may be premature. The legislation very much has the potential to change the manner in which water is provided, possibly even more so than the Bill 26 amendments to and the 'White Paper' redrafting of the *Municipal Act*. It therefore has the potential to have a profound impact on the operation and governance of water systems in Ontario.

There is a significant difference between the government's electricity and municipal initiatives. The amendments and draft rewrite of the municipal legislation, as noted in my earlier reports on the Ministry of Municipal Affairs' activities, only have implications for the governance of water utilities of the province. Moreover, the draft rewrite of the act has not yet become law. The electricity initiative, for its part, is now law. While it can lead to changes in governance as well, it can also affect the management of the water systems, and, indirectly, the ownership.

In this report, three main avenues in which the *Electricity Competition Act* has the potential to affect the provision of water in Ontario are identified:

- Water & the Conversion of MEUs to a Share Ownership Utilities
- Water & the Mergers of MEUs Across Municipal Boundaries
- Water & the Impact of Share Ownership and Merged MEUs on Local Control

These three subject matters will be of importance to all of Ontario's municipal water utilities, but will obviously be immediately relevant for the approximately 130 water utilities that are currently run through municipal PUCs that operate both water and electricity or more services. The reason is that decisions are required in the very near future on what to do with their water systems.

While each of the subjects is equally important and they are all interrelated, the particular order of presentation of the three serves to crystallize four options available to municipalities. These options, which will be presented as a concluding section, are as follows:

- a municipality can run the water directly
- a re-created MEU, whose ownership is clarified in municipal hands, can run the water system on behalf of municipalities for which it is the electric provider, but cannot own a water utility itself
- a municipality can contract the water system to an alternative service delivery provider, not unlike the service that would be performed by an MEU, and
- a municipality could keep or create a public utility commission (but without electricity)

While the use of an MEU to provide water will be attractive in many municipalities, there are reasons why other municipalities or their water utilities may want to consider maintaining the traditional public utility concept for water rather than simply assign the water system to the new electric company. After reviewing the three issue areas below, I will elaborate on all the options, including how the public utility concept may be pursued independent of the re-creation of the MEUs where this makes sense.

2. Water & the Conversion of MEUs to Share Ownership Utilities

2.1 The Framework for Share Ownership MEUs

Key Findings:

- a share ownership MEU structure is designed to mimic private sector behaviour and will affect water utilities directly where they are operated by MEUs
- water utilities remain under the *Public Utilities Act*, but will be run by or judged in comparison to MEUs run under the commercial *OBCA* legislation
- performance comparisons between MEUs and water utilities will occur whether the water system is operated by the MEU or by the municipality
- a key objective of the electricity legislation is removal of the differentiation between public and private distribution utilities – municipalities must either re-create the MEUs as *OBCA* corporations or sell to or merge with other corporations
- change of legislative foundation is significant for water utilities because MEUs will end up with an ownership and governance character similar to private utilities, even if most municipalities continue to own the shares
- with a majority municipal ownership, an MEU can only manage a water system; ownership of water must remain with the municipality unless the MEU has a majority private ownership
- an *OBCA* structure for MEUs is driven by the government's desire to facilitate their commercialization; MEUs will be run like any other share-owned companies, with private sector debt ratios and with profits and dividends
- a commercial MEU operation will not be without financial risk to the owners because, on the commodity side of the electric industry, the MEUs will have to win market share
- a commercial footing for MEUs is a quasi-privatization because the municipalities are not compelled to maintain ownership, and can sell a stake in the utility or the whole thing
- once in share ownership, the shares can be sold on the open market or merged with other MEUs or with other share ownership utilities, like gas companies, for joint ventures

Analysis:

The conversion of MEUs to a share ownership structure is significant for all Ontario water utilities, whether they are currently operated through municipal departments or public utilities commissions. The reason is that the share ownership structure is designed to mimic private sector behaviour. While this will only affect water utilities directly where they are operated by MEUs, it nonetheless affects others as well. It will naturally lead to performance comparisons between water utilities that are operated by municipalities or through successor MEU corporations.

In terms of electric industry restructuring, one of the key objectives of the government's electricity legislation is to remove the differentiation between public and private distribution utilities in Ontario. Within two years of the passage of the electricity legislation (October 2000),

municipalities must either re-create the MEUs under the *Ontario Business Corporations Act (OBCA)* or sell the MEU or merge it with other MEUs. (Municipalities are now the official and formally declared owners of the MEUs). (The sale issue will be discussed in this section; mergers will be discussed in the next section).

This change of legislative foundation is more than cosmetic in its impact for Ontario's municipal water utilities, let alone MEUs. It is significant because MEUs will end up with an ownership and governance character similar to private utilities, even if in all likelihood most municipalities continue to own the shares. This is the practical effect of moving the MEUs to an *OBCA* foundation and removing them from their long history under the *Public Utilities Act*. The water utilities will remain under the latter act, but be run by or judged in comparison to utilities run under the commercial *OBCA* legislation. As long as the MEU has a majority municipal ownership, it can only manage the water system, with the ownership remaining with the municipality.

Giving the MEUs an *OBCA* ownership and governance structure is driven by the government's desire to facilitate the commercialization of their affairs. The government expects that they will be run like private businesses, and the municipalities are given the tools to see this happens. As the MEU shareholders, the municipalities are given the power to appoint MEU directors, who are, in turn, expected to run the businesses like any other share-owned companies. This means they will run them with private utility debt ratios and with profits and dividends.

Such a commercial operation, it should be noted, will not be without financial risk to the owners. This is especially the case because the commodity side of the electric industry is being opened up to retail competition for customers – not just wholesale competition to the utilities. Since the customers are no longer captives, the MEUs now have to win their market share.

By giving the MEUs a commercial footing, the government has, in fact, initiated a quasi-privatization of their affairs. But this is only part of the story. It is also an avenue for the partial or full privatization of the MEUs. Once they are converted to a share ownership structure, the municipal owners are not compelled to maintain ownership of the shares, and indeed can sell a stake in the utility or the whole thing. The shares can be sold on the open market, or (as discussed in the next section) they can be brought together with other MEUs for mergers or with other share ownership utilities, like gas companies, for joint ventures.

2.2 Implications of Share Ownership for Water Utilities

Key Findings:

- where a share ownership MEU manages a water system for a municipality, a contractual agreement between the municipality and the *OBCA* MEU would be required
- contractual arrangements for water would remain in the hands of the share ownership MEU, irrespective of whom the owners may now be, unless special provision had been made in the contract or was part of the negotiations for the share sale

- while a municipality used to have to have a referendum to sell an electric or water utility, no such complication exists under the new *Electricity Competition Act* or the recently amended (Bill 26) *Municipal Franchises Act*
- the prohibition on MEUs owning water systems only applies to MEUs that have a majority ownership by municipalities
- a share sale will be significant even in cases where less than a majority of MEU shares are sold because a large private shareholder would be entitled to representation on the MEUs board of directors
- directors have a fiduciary responsibility for promoting the best interests of the *OBCA* corporation; profits and dividends, rather than traditional objectives of good customer service and a high water quality, will be among the paramount considerations
- sale of a water system can be controlled in a single municipality through negotiation for the MEU sale; where the MEU serves many municipalities, control of ownership would be more difficult

Analysis:

A partial or full privatization of an MEU could have broad implications for the operation of a municipally owned water system. Where a share ownership MEU manages the water system, it would need to be operated under a contractual arrangement with the MEU. This would presumably or possibly be under a long-term contractual arrangement that is a legally binding agreement between the municipality and the *OBCA* MEU.

Formal, contractual arrangements between the municipality and the MEU for the water system pose an interesting set of issues. The reason is that the ownership of the MEU, while it begins in municipal hands, is not required to remain in municipal hands. Prior to Bill 26, a municipality had to have a referendum under the *Municipal Franchises Act* to transfer the operation of a MEU or water system to the private sector. But no such complication will exist for the ownership of MEUs under the new *Electricity Competition Act* (and no such hurdle exists for selling water systems or contracting out their management under the amended *Municipal Act*).

A municipality is free to sell all or part of its shares in the MEU to other municipalities with MEUs or other parties, such as gas companies and any another company interested in the electric distribution business. This raises two considerations for the operation of the water system. The first is that the contractual arrangements for the provision of water would remain in the hands of the share ownership MEU, irrespective of whom the owners may now be. The only exception would be where a special provision had been made in the contract or as part of the negotiations for the share sale. The second is that the prohibition on MEUs owning water systems only applies to MEUs that remain with a municipal ownership majority.

This ability to sell will be significant even in cases where less than a majority of the MEU's shares have been transferred to private companies. The reason is that such a private company would be entitled to representation on the MEUs board of directors. Like any other directors,

these directors will have a fiduciary responsibility for promoting the best interests of the *OBCA* corporation.

Incorporating the perspective of the private sector into the 'best interests' may, if not will, present new challenges for the operation of public utilities. Profits and dividends, for starters, will be among the paramount considerations. While these are not unimportant, they do not necessarily mesh with the traditional water utility community objectives of good customer service and a high water quality.

The situation where a loss of control over the water system occurs may, admittedly, be more hypothetical than real, but is nonetheless possible. It can be easily controlled in the case of a single municipality. The municipality, as the sole owner of the MEU before the share sale, could determine the fate of the water system in the negotiation for the sale of MEU shares to the private sector. However, the situation would be one that a municipality would have more difficulty controlling if the MEU served many municipalities and, thus, had many individual municipal owners able to sell their shares. This is the subject of the next section.

3. Water & the Merger of MEUs across Municipal Boundaries

3.1 Framework for Mergers of MEUs

Key Findings:

- MEU rationalization is a second key government objective; it can occur through sale of assets, consolidations through mergers across municipal boundaries; merger with other *OBCA* corporations, including Ontario Hydro's successors and gas companies
- from the government's perspective, municipal boundaries are not considered to be a commercial base; economies of scale are hindered by the existence of too many MEUs; a competitive commodity supply environment will not work well with too many distributors; and too many distributors exist for third-party regulation to work effectively
- water differs from electricity because water systems are municipally delimited rather than physically connected and rural areas generally do not have integrated water supplies; water is still a natural monopoly; water lends itself to a full-cost pass through infrastructure pricing scheme, not formal regulation
- commercial imperatives do not apply in the municipal water industry; electricity and water are on divergent paths in many but not all municipalities
- consolidations may make sense in the water industry for some municipalities, but the commercial imperatives of the electric businesses do not apply equally to water
- government is expediting MEU rationalization by giving municipalities financial incentives, including an escapes from taxation and the ability to reap any potential dividends from the increased efficiencies
- merged MEUs have a different effect on the water utility business from the case of a single municipality's MEU because each participating municipality is represented only through whatever terms are established in the shareholder agreement
- one or more municipalities may be the dominant shareholders and smaller municipalities may not have sufficient shares to receive representation on the board of directors

Analysis:

The commercialization of the electric distribution business is only part of the government's *Electricity Competition Act* objectives. A close second to this objective is the rationalization of the number of MEUs. While this can occur through sale of assets, as noted above, it can also result from consolidations through mergers across municipal boundaries. The merger partners can be any other *OBCA* corporation, including other MEUs, the Ontario Hydro successor company for the wires assets, or private companies like Consumers Gas or Union Gas.

By overlaying open competitive forces on the electric industry, the government is of the view, rightly or wrongly, that municipal boundaries do not necessarily make for natural or sustainable commercial boundaries. There will be cases where merger consolidations may make sense in the

municipal water industry, but the difference between the two industries is the influence of the commercial imperatives on the operation of the businesses.

The need for commercialization does not apply to the same degree in the municipal water industry. The consequence is that electricity and water are on divergent paths in many but not all municipalities in terms of the issue of consolidation and merger. This is not yet readily evident because the commercialized behaviour of the MEUs has yet to take hold. There may, however, be cases where a municipality believes that the water system could benefit from being more commercial, and thus be put in with the *OBCA* MEU even if it was not previously part of a PUC.

On interpretation, the government has three reasons for believing that there are far too many electric distributors. First, a large number of distributors are a hindrance to economies of scale in distribution infrastructure, including the duplication in rural areas with Ontario Hydro's system. Second, many distributors are thought to be too small to be effective in an open and competitive environment for electricity commodity supply. Third, too many distributors exist for the new formal third-party regulation of distributors by the Ontario Energy Board to work effectively and smoothly.

Water provision presents an interesting contrast to this reasoning on all three counts. First, water systems are, for the most part, municipally delimited rather than physically connected and rural areas generally do not have integrated water supplies. Second, water is still a natural monopoly business. Third, water lends itself to a full-cost pass through infrastructure pricing scheme. Electricity will have performance-based 'benchmark' regulation applied.

In order to expedite the rationalization process, the government has provided municipalities with financial incentives. This is offered as an escape from taxation on the sale and transfer of the MEU assets (for an interim period). It also presents itself as the ability to reap any potential dividends that result from the increased efficiencies from larger operating scale. Where these incentives makes sense, the municipalities will seek mergers with neighbours or, in effect, forego the incentives.

The merged MEU will have a different effect on the water utility business from the case of the single municipality's MEU. Besides there being many municipalities participating in the ownership of the MEU, each would be represented through whatever terms are established in the shareholder agreement, if one is in fact negotiated.

This is a significant point because, depending on the circumstance, one or more municipalities may be the dominant shareholders. Similarly, smaller municipalities, depending on the mix of participants, may not have sufficient shares to receive representation on the board of directors. In any event, the management of the water system would be performed through a contractual agreement for the municipality.

Where there are pre-existing PUCs, there will be two ready merger options on hand for the water system that are affected. The first option is that the new, amalgamated MEUs can operate the water systems in the home municipality, almost as if nothing had changed. Thus, this is not

unlike the case noted for a single municipality in the previous section, save for the merger increasing the number of owners. The second option is that the municipality can keep the water system separate from the newly formed *OBCA* MEU, placing its operation within the municipal government or continuing a separate PUC or water commission. (The second case will be addressed in sections 4 and 5 on local control and options, respectively).

3.2 Implications of Mergers for Water Systems

Key Findings:

- deciding the future of the water system in the context of MEU restructuring is a significant municipal issue that complicates any merger decision
- one potential risk of placing the water system with the *OBCA* MEU is that the municipality could end up with having little direct control over its operation; representation on the board or directors may not be forthcoming or may be negligible
- all the municipality has to fall back on when representation is weak or negligible is a contractual agreement with the share ownership MEU; this would be similar to the operation of the water system by a private company, save for the fact the shareholders in the company are neighbouring municipalities
- with partners who are neighbours, a municipality may not place sufficient emphasis on ensuring that its interests are well protected in the contract
- not all municipalities that join an MEU merger will also merge their water systems, leaving the water systems of those that do with partners whose primary interest is running electric distribution systems and competitive commodity businesses
- no assurances can exist that one or more municipalities will not sell their shares to a private sector business, with the water contract possibly affected
- private equity can also enter an *OBCA* MEU through, for example, the contribution of assets or cash from a gas or other private company; transfer of shares can be in part or whole for the impact of the privatization to be felt
- the risk to contributing a water system to a merged MEU is that it could end up being passed into private hands; the contractual arrangement for water with the *OBCA* company would be subject to change or termination only through the specified terms of the contract

Analysis:

Deciding the future of the water system is a significant issue for a municipality. One potential risk of placing the water system with the *OBCA* MEU is that the municipality could end up with having little direct control over the operation of the water system. Representation on the board or directors may or may not be forthcoming, and even where it does exist it may be negligible.

In cases where a municipality has weak or no representation on the MEU board of directors, all the municipality has to fall back on is a contractual agreement with the share ownership MEU. The result would be that the municipality would have an arrangement not that dissimilar to the

operation of the water system by a private company, save for the fact the shareholders in the company are neighbouring municipalities.

There are clearly many considerations a municipality to weigh when deciding to enter a merger. However, the addition of water is very important to the mix because it can change the decision calculus for a municipality wanting to join the merger. Given that any one municipality goes into the merger with partners who are neighbours, it may in fact not place sufficient emphasis on ensuring that its interests are well protected in the contract. This would be a serious neglect of the interest of the municipality. As the saying goes, good fences, or in this case good contracts, make for good neighbours.

There are two other factors to consider in the addition of the municipal water system to an *OBCA* MEU. The first is that not all municipalities that join the merger would necessarily put their water systems with the company. In this situation the municipalities that do put their water systems in the MEU run the risk of having their water systems run by partners in a merger whose primary focus is running electric distribution systems and competitive commodity businesses. This has the potential to create a divergence with the objectives of the water system. This potential for a divergence of interests would be multiplied as a result of the second factor to consider.

The second factor is that there is no assurance that one or more municipalities will not sell their shares to a private sector business. Only a shareholder agreement with restrictive provisions could prohibit such flexibility. Given the flexibility of the *OBCA* foundation of the MEU, the companies can easily be transferred into other hands, no different than the case for any private companies. This flexibility underlies the government's objective.

A permutation of the second factor would be that private equity can enter an *OBCA* MEU through other means. This could be, for example, through the contribution of assets or cash from a gas or other private company. And similar to the example provided in section 2, the transfer of shares can be in part or whole for the impact of the privatization to be felt.

The net result of the above is that there are risks to consider for municipalities that contribute a water system to a merged MEU. The municipalities need to be concerned that the water system operation could end up being passed into private hands. Moreover, because the municipality has a contractual arrangement with the *OBCA* company, the contract could only be subject to change or termination through the specified terms of the contract. There is, therefore, a lot to consider when passing the operation of a water system to an MEU or a merged MEU. In fact, no concern is probably more politically important than the ability to exercise local control. It is to this subject that the next section turns.

4. Water & Impact of Share and Merged MEUs on Local Control

4.1 The Framework of Local Control of Water Utilities

Key Findings:

- one overlooked factor in restructuring of the electric industry is the local control of MEUs; water utilities that are passed to them will be affected
- private sector governance structures are being grafted of onto the traditionally publicly-owned utilities; for water systems that were part of PUCs, this heralds the demise of autonomous, elected water utility governance
- for MEUs, this is a corollary of the government's commercialization imperative, but it is also consistent with the government's other municipal objectives
- for the case of PUCs or a water department that is passed to an *OBCA* MEU, the municipality exchanges customer control through elections for contractual control by the council through legal agreements
- autonomous, elected utility commissions are not held in high esteem by the advocates of the commercialization of public utilities
- elected commissions have their origin, in part, in the importance of keeping municipal politics out of public utilities to avoid cross-subsidies and possible council corruption in awarding contracts, etc., and ensure that the customers' interest are kept foremost
- a more publicly significant justification stems from the at-cost public services purpose and character of the utilities
- public utilities operate like customer cooperatives, promoting the 'greatest good for the greatest number'

Analysis:

Likely one of the most overlooked dimension to the changes underway in the restructuring of the electric industry is the local control of MEUs. By implication, the water utilities that are passed to them are also affected. While this is very much a corollary of the government's commercialization imperative for electricity, it is nonetheless consistent with the government's other objectives on the municipal front, especially as witnessed in the Bill 26 amendments to the *Municipal Act*.

By moving to the *OBCA* share ownership structure, private sector governance structures are, in fact, being grafted of onto the traditionally publicly owned utilities. The direct result, in the case of water that was part of a PUC, is the demise of autonomous, elected utility commissions. In this case and the other case where or if a water department is passed to an MEU, the municipality exchanges customer control through elections to contractual control by the council through agreements.

The autonomous, elected nature of publicly elected utility commissions finds its origin in two primary factors, although the advocates of the commercialization of public utilities hold neither in high esteem. The first factor is the importance of keeping municipal politics out of the public utility business and its decision-making. This justification has its origins in the desire to remove cross-subsidies and avoid possible council corruption in awarding contracts, etc. It stems from the view that the utilities needed to be publicly owned businesses with the customers' interest kept foremost rather than the councils' interests.

Although the first has not been an unimportant factor for autonomous, elected commissions, the second has been more publicly significant. It affects the purpose and character of the operation of the utilities. The second is that the utilities were organized to deliver quality public services on an at-cost basis. This served the 'greatest good for the greatest number' objective of facilitating economic growth. For this reason, the utilities were operated, in business terms, as customer cooperatives, although silently owned by the municipalities.

4.2 Implications for Local Control of Water Utilities

Key Findings:

- *Electricity Competition Act* replaces elected commissioners with appointed directors, and thereby changes the accountability from electors to shareholders
- this is similar to having commissioners who owe their appointment to the council, with the difference being that directors have the fiduciary duty to the interests of the *OBCA* corporation; the customer is, therefore, a second order consideration
- Bill 26 set this process by permitting a municipal restructuring order to change the utility governance or take over a water commission or the water component of a PUC
- local control will be important in municipalities where choices need to be or will be made on the future of a water system
- where a water system is passed to the *OBCA* MEU, the transfer will alter the governance of the water system in a manner that may reduce local control
- water will change from a customer-run to a council-run utility, assuming the MEU's shares stay with the municipality
- if shares are sold, the water system would be in private hands for the duration of the contract, unless the contract specified otherwise
- bringing a water system into the public works department or a PUC will provide an assurance that the operation of the utility would remain in municipal hands
- a water department or commission will have greater public accountability than it would under an *OBCA* MEU because the latter is at least one step removed from the elected councillors or commissioners

Analysis:

In most municipalities with MEUs, municipal electors, as a substitute for customers, have until now, and with some exceptions, directly elected the utility commissioners. The *Electricity Competition Act* will replace this system with one of utility directors being appointed by shareholders. This arrangement is synonymous with the exceptions where municipalities have appointed the utility commissioners.

While the difference of appointed and elected may seem negligible, for some, it is substantial in terms of lines of accountability. The reason lies in the fact that the appointed directors will owe their appointment to their shareholders. This will not be unlike appointed commissioners owing their appointment to the council, if the council is the shareholder. The only difference is that directors have the fiduciary duty to the interests of the *OBCA* corporation, which in this case is the MEU. The customer is, therefore, a second order consideration.

This process was, in fact, set in motion for many municipalities through the sweeping powers municipalities received under the Bill 26 amendments to the *Municipal Act*. Through the auspices of a municipal restructuring order, any municipality could override the *Public Utilities Act* and change the governance of a utility commission. And under general municipal powers, any municipality could take over a water commission or the water component of a PUC. Electric utilities were excluded for the time being in anticipation of the *Electricity Competition Act*.

This issue of local control will be important in municipalities where choices need to be or will be made on the future of a water system. If the water system is passed to the *OBCA* corporation for operation under a management contract, the transfer will, in effect, alter the governance of the water system in a manner that may reduce local control. It will move from a *de facto* customer-run utility cooperative to a council-run utility, assuming the MEU's shares stay with the municipality. Should the shares be sold to the private sector, either initially or later on, the water system would then be in private hands for the duration of the contract, unless the contract specified otherwise.

In such a situation, it may be a better outcome for the municipality to bring the water system into the public works department or a new water commission for two reasons. The first is that this would provide an assurance that the operation of the utility would remain in municipal hands. The second is that the water utility would have greater public accountability than it would under an *OBCA* corporation. The council or commission is elected, whereas the *OBCA* corporation is at least one step removed from even the elected councillors or commissioners. These are nonetheless some of the options available and the subject to be discussed in the next section.



5. Options for Structuring Water Governance and Operation

Key Findings:

- municipalities that are rethinking the provision of water because of the *Electricity Competition Act* have four available options. They can utilize:
 - a municipal department
 - a contractual agreement with an *OBCA* MEU
 - a contractual agreement with an ASD provider like OCWA
 - a commission or PUC
- a municipal department needs little explanation; it is well known by municipal leaders
- a contract with an *OBCA* MEU should give careful scrutiny since the governance is appointed by the shareholders, which may or may not leave the council the flexibility to exercise local control
- a contract with an alternative service delivery provider is not unlike that with an *OBCA* MEU, save for the cases where the MEU shares remain in municipal hands
- commissions may still be an attractive option, although by peculiar circumstance they are incorrectly thought not to be available
- any PUC providing water can no longer provide electricity; commissions or PUCs can still exist or be created, just not for electricity service
- although commissions are largely out of favour, a large window of opportunity exists for establishing commissions
- draft revisions to the *Municipal Act* have the effect of banning the establishment of any new commissions, but these are not yet law; a window to establish a water commission or a PUC that includes water (but not electricity) will more than likely exist until at least the next election
- the commission model or public utility concept still has merit for customer-focused utility services, especially for hard services, such as water and sewers
- a water commission or PUC that includes water (without electricity) will be an attractive local option where an MEU is merged across municipal boundaries or sold
- a water commission is a sound alternative to contracting with an MEU that either may not be run from the municipality or may not remain owned by the municipality or even a group of municipalities

Analysis:

If a municipality is presented with the need to rethink the provision of water as a result of the *Electricity Competition Act*, there are four available options. These are to operate the water system through a municipal department, a contractual agreement with an *OBCA* MEU, a contractual agreement with an alternative service delivery (ASD) provider like OCWA, or a commission or PUC.

The first two options need little explanation because all municipal leaders readily understand the first and the second has been explained above. It is worth repeating, however, that the second – a contractual agreement with an *OBCA* MEU – is something for which the municipality should give careful scrutiny. The reason is that the governance is appointed by the shareholders, which may or may end up not leaving the council the flexibility to exercise local control.

A contractual agreement with an ASD provider is not unlike the case of a contract with an *OBCA* MEU. Although it has not been discussed in this report until this time, the reason is that it has no direct bearing on the *Electricity Competition Act*. The situation would only be different from a contract with an *OBCA* MEU if the municipality still held the MEU's shares. The ASD companies are privately owned, such as Philip Environmental, or publicly owned, such as OCWA, although the latter is having its ownership reviewed for possible privatization.

The fourth option, a commission, may still present itself as an attractive option. More will be said here about this option than the others because, by peculiar circumstance, it is incorrectly thought not to be available. In fact, the new electricity legislation only states that any PUC providing water can no longer provide electricity. It does not state that commissions or PUCs can no longer continue to exist. Rather, the constraint is only that there can be no new commissions created for electricity service.

The commission option is not widely discussed primarily because the commission structure is largely out of favour with the Ministry of Municipal Affairs and the provincial government more generally. There is nonetheless still a quite large window of opportunity for establishing commissions, although the rules are much tighter than they were prior to the Bill 26 amendments to the *Municipal Act*.

Bill 26 did make it quite easy for a municipality to disband an autonomous commission and made it quite difficult to start one from scratch by taking away the referendum option for establishing commissions. Commissions, however, are not yet prohibited. While the draft revisions to the *Municipal Act* have the effect of banning the establishment of any new commissions, they have not been introduced and thus are not yet law. Should they be passed, existing commissions could continue to exist, but, once disbanded, could never again be established. Similarly, new commissions would also be impossible to create.

Until such time as the revisions are passed, a municipality can still establish a water commission or a PUC that includes water (but not electricity). The window will more than likely exist until at least the next election. A council would simply have to pass the necessary bylaw under the rules laid out in the *Public Utilities Act*.

Establishing a water commission or non-electric PUC may be an attractive option for two reasons. The first is that, despite the changes in the electric industry, the commission model or public utility concept still has merit for providing customer-focused utility services. The second is that a municipality could utilize the model to put the hard services in a PUC, such as water and sewers, but even roads and recycling, and keep the soft services with the council.

A water commission or PUC that includes water (without electricity) may especially be attractive where there is likelihood that the MEU will be merged across municipal boundaries or be sold. It is a sound alternative to placing the water system under contract with an MEU that may not be run from the municipality or may not remain owned by the municipality or even a group of municipalities. It is also a means to permit the value of commissions to continue to exist, as opposed to simply moving water into the municipal government as a result of the changes taking place in the electric industry.

