

# Guidelines for Governance of the Electricity Sector in Canada



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# Executive Summary

This document has been written to promote the development of best practices in governance of the electric utility sector in Canada. It results from a combination of academic research on electricity sector governance in Canada and abroad, and an assessment of governance best practices; and from discussions among industry leaders and experts at a conference on governance held in Toronto on 4 June, 2010, organized by the Council for Clean and Reliable Electricity, the Richard Ivey School of Business, University of Western Ontario and the University of Waterloo. Approximately 100 leaders from the electricity industry, government, labour unions, the financial sector, consumer advocates, NGOs and other stakeholder organizations participated in debate and discussion on electricity governance. A broad range of individuals have contributed to and endorsed the policy recommendations contained herein.

Several overarching themes emerged during the course of conference discussions:

**ELECTRICITY POLICY HAS BECOME VASTLY MORE COMPLEX IN THE LAST DECADE** due to new technology developments in power generation (e.g. renewable fuel sources) and smart metering, and also due to the increasing political priority placed on environmental stewardship. These forces have fundamental implications for the structure of the industry, capital investment needs and regulatory frameworks. Traditional approaches are not necessarily appropriate given the new policy challenges, yet there is considerable uncertainty about the best direction for policy-makers to take. The risks of making policy errors or mistakes are significant as are the implications for the efficient functioning of the sector.

**THERE IS AN URGENT NEED FOR MORE INFORMED DEBATE ON POLICY OPTIONS IN THE ELECTRICITY SECTOR.** A common observation among conference speakers was the lack of educated opinion and public debate on policy alternatives and consequences in a broad range of forums – within governments, the media, universities and independent research institutes. At a time of fundamental transformation in the industry, the benefits of a more extensive public debate are clear: first, major policy mistakes are more likely to be avoided since unwanted policy consequences will be identified earlier; and second, it will be easier to reach a broader consensus about policy reform if all stakeholders have participated in discussions – which means policies are likely to enjoy longer-term support and survival, even in the face of unanticipated events that could otherwise destabilize reform programs.

**GOVERNANCE ISSUES HAVE AS MUCH OF AN INFLUENCE ON UTILITY OPERATIONS AND PERFORMANCE AS DO REGULATORY POLICIES.** A comprehensive public policy approach to electricity sector reform thus requires an integrated assessment of regulatory policies and governance regimes.

Conference participants voted through an internet survey on policy reform recommendations contained in a draft document that was publicly circulated after the conference. For 80% of the policy recommendations in the report, a majority of respondents indicated that each was of High Importance, demonstrating a strong consensus for implementing governance reforms. A central finding was the overwhelming support for strengthening the independence of regulatory agencies and boards: 93% of survey respondents rated as highly important the recommendation that:

- *“The principle of independence of agency decision-making should be formally stated in legislation”*

The second and third highest priorities identified by respondents were:

- *“Major policy objectives should be specified in legislation rather than in directives”*
- *“Agency board members should be appointed for fixed, five year terms, with renewal limited to one additional term of five years”*

Survey respondents' top three priorities for reforming the governance of Crown corporations were as follows:

- *“The government’s ownership function and other functions, such as market regulation and industrial policy, should be clearly separated to avoid a conflict of interest”*
- *“Utility senior management should be able to make operational decisions without obtaining prior government approval”*
- *“Utility boards should formulate and review corporate strategy in light of the utility’s overall objectives, establish performance indicators, identify key risks, monitor disclosure and communication, ensure the reliability of financial statements, assess managerial performance and develop succession plans for key executives”*

## Policy Context

As governments around the world have sought to improve the operational performance of electric utility sectors, and also to encourage private investment in utility infrastructure, a policy debate has emerged on the best practices for regulating both privately-owned and government-owned electric utilities. A central element of this debate concerns optimal governance practices, including (a) governance arrangements for regulatory agencies and (b) governance structures for government-owned utilities and Crown corporations. *Regulatory governance* consists of the role and powers of regulatory agencies, and their relationships with ministries, parliaments and courts who oversee them – i.e. *how* regulatory policies are made and by *whom*. *Utility governance* consists of the structure of relationships between the utilities and their government shareholders, and the respective roles of utility boards of directors, executive officers and government ministers. Alternative structures differ in their relative balance between political control of utilities and operational independence.

...governance issues have as much of an influence on utility operations and performance as do regulatory policies.

While policy attention often focuses on specific regulatory policies – such as incentive pricing schemes, technology choices, allowed rates of return and so forth, research suggests that governance issues have as much of an influence on utility operations and performance as do regulatory policies. A comprehensive public policy approach to electricity sector reform thus requires an integrated assessment of regulatory policies and regulatory governance regimes.

# Part I: Improving the Governance of Regulatory Agencies



## **How Regulatory Governance Affects Utility Operations and Performance**

Academic research has found that the structure of regulatory governance – notably as it affects agency independence - has a significant effect on the ability of governments to attract and sustain investment in the utilities sector. As the time frame for project returns lengthens – 20 years is common and 40 years is not uncommon in electricity infrastructure projects – the impact of regulatory governance in the assessment of the overall regulatory climate becomes more central. Studies of the renewable power generation sector have found that firms rate regulatory governance factors to be more important in their location decisions than operational and market factors when comparing alternative jurisdictions for their investments.

Strong regulatory governance regimes consist of expert agencies that operate largely independently of day-to-day political control, but under legislative mandates and procedural requirements that safeguard the rights of stakeholders. Such regimes can provide credible assurances to industry and stakeholders that policies will not change in an arbitrary or unpredictable fashion, for instance in response to new political or economic pressures, after investments have been made. Regulatory governance regimes that enhance agency independence from political intervention in day-to-day decision-making have the benefit of encouraging greater levels of private investment and at lower cost, which benefits consumers, since perceived regulatory risks are reduced. Such governance structures are thus likely to have the support of both industry and consumer stakeholder groups.

Weak regulatory governance, on the other hand, is characterized by a more politicized policy-making environment where the government, rather than agencies, has greater control over regulatory policies. In this type of environment it is more difficult to achieve credible commitment to future investor and stakeholder protection, heightening perceptions of regulatory risk. In the absence of adequate regulatory governance, a jurisdiction may encounter multiple types of inefficiencies in its electricity sector – underinvestment, minimization of maintenance expenditures and fluctuating rates of capital investment. Ultimately, the negative effects of non-credible regulatory governance can lead to government ownership becoming the default mode of operation, as has been the case in many developing countries.

The regulatory challenge for policy-makers therefore lies not just in designing regulatory incentive structures that encourage economically efficient utility operations but also in designing regulatory governance frameworks that constrain the political and administrative actors who have jurisdiction over the industry. However, designing regulatory arrangements that are flexible enough to make balanced policy decisions in response to unanticipated events but that are also rigid enough to insulate policy from political pressures is a difficult task.

## Policy Recommendations

Regulatory governance in many provinces in Canada is quite exposed to political influence, subjecting regulatory agencies and hence the electricity industry to a greater degree of direct political control than is the case in some other jurisdictions (e.g. the United States where multiple political checks and balances confer a degree of autonomy on regulatory agencies). In each province, individual ministers have substantial authority to issue directives to agencies, to make specific regulatory policies, to establish budgets and/or to make appointments. The role of provincial legislatures in monitoring, reviewing or approving agency or ministerial actions is limited, further concentrating power in the ministry. Although there are some differences between the provinces, these are mainly a matter of degree. There is thus considerable scope to improve the quality of regulatory governance.

The ability of single ministers to exert political control over many aspects of agency decision-making has fundamental consequences for the development pattern of regulatory policy over time. In particular, political control puts at risk the long-term stability and credibility of policy since key dimensions may be modified at the discretion of an individual minister by initiating directives to agencies or even simply by proposing to do so. Changes over time in ministerial policy preferences, which may occur in response to the appointment of new ministers, shifting party political priorities or lobbying by organized interest groups, can thus lead to rapidly shifting agency decisions. Yet research studies find that private sector energy firms tend to rate energy policy stability as highly important in their investment allocation decisions across different jurisdictions.

**THERE ARE TWO BROAD STRATEGIES FOR GOVERNANCE REFORM:** first, *enshrining specific policy objectives in legislation*, for instance renewable energy capacity or emissions targets, will ‘hard wire’ policy commitments and reduce the degree of ex post political discretion in policy-making. Even though the majority party in the provincial legislature controls the legislative agenda, the legislative process provides opportunities for public debate and consultation that are not required for ministerial directives. Extensive consultation has the benefit of reducing the risk of policy errors since multiple parties have an opportunity to provide information on policy consequences and alternatives that may not have been anticipated by the sponsoring Ministry. Enacting legislation also demands time and resources from the initiating parties, implying that once enacted, legislation is not easily reversed or modified.

A second approach to stabilizing policy over time is to *strengthen agency independence* from government control, as has been the practice in other jurisdictions such as the U.S. and U.K. that have also encouraged private sector investment in the electricity sector. Further, the decision-making authority with respect to policy details could be conferred on the regulatory agencies, subject to administrative procedural requirements, but without the need for explicit ministerial initiation or approval.

Specific reform recommendations that achieve these objectives are outlined below:

**i) STRENGTHEN AGENCY BOARD APPOINTMENT PROCESSES**

- a) Agency board members should be appointed for fixed, five year terms, with renewal limited to one additional term of five years.
- b) Terms of appointment should not coincide with political election cycles and individual appointments to a particular agency should be staggered.
- c) Agency board members may not be dismissed before the end of the term of appointment except for due cause.

**ii) ENSURE FINANCIAL AND ORGANIZATIONAL AUTONOMY OF AGENCY**

- a) Agencies should have sufficient and predictable financial resources to operate and fulfill their policy-making functions.
- b) Agencies should obtain their funds through rate levies on consumer bills rather than through government appropriations.
- c) Agencies should maintain control over their internal organization and personnel decisions, including selection of the most senior staff person (Chief Executive Officer or equivalent).

**iii) CREATE ROBUST AGENCY CHARACTERISTICS**

- a) Professional experience or qualification requirements should be established as selection criteria for agency board members.
- b) Agency board composition should represent a broad set of stakeholders.
- c) Agencies should publicly disclose all communications with interested parties.

**iv) ENABLE RIGOROUS APPEALS PROCESSES**

- a) Interested parties should have the right to appeal the decisions of regulatory agencies through a process that ultimately leads to the courts on matters of process.
- b) Funding should be available to consumers to represent their interests in agency decision-making processes.

**v) ENHANCE AGENCY INDEPENDENCE**

- a) The principle of independence of agency decision-making should be formally stated in legislation.
- b) Major policy objectives should be specified in legislation rather than in directives.
- c) Ministers should not have veto power over agency decisions.
- d) Ministers should not be able to issue directives to agencies.
- e) Agencies should have formal reporting requirements to the legislature as well as to the minister.

## Part II: Improving the Governance of Government-owned Utilities



## Overview

Corporate governance is the process and structure for overseeing the corporation's strategic direction and management to ensure that it effectively meets its mandate and objectives. Government-owned utilities and enterprises (known in most parts of the world as State-owned Entities or SOEs) have unique governance challenges. Unlike private sector firms, SOEs typically have both profit-seeking and government-mandated social objectives. On the one hand, SOEs are often expected to operate in a commercial manner. Yet they also operate in a political context and are subject to strategic direction and control by government shareholders. Because of the inherent tension between commercial and political objectives, SOEs typically perform less efficiently than their private sector counterparts. Careful corporate governance reforms, however, have the potential to improve performance and unlock significant value, even in situations where privatization is not feasible for practical or political reasons.

# Careful corporate governance reforms, however, have the potential to improve performance and unlock significant value...

The OECD has developed policy guidelines to help governments improve how they exercise ownership of SOEs. In Canada, publicly-owned utilities' governance structures seem to comply with OECD guidelines. The government's ownership policy vis-à-vis the utility tends to be formalized in an agreement, such as a "letter of expectations" or "memorandum of agreement". The government ordinarily appoints directors from the private sector to the utilities' boards. As in the private sector, boards are responsible for reviewing and approving the utilities' strategic plans, appointing and evaluating the CEO, appointing special committees and supervising the utilities' internal and external audits. Utilities' annual reports usually disclose material information and comply with national corporate accounting and auditing standards. Employees, including directors, are expected to comply with internal ethics codes.

However, there are some critical areas where utilities' governance structures do not comply with OECD guidelines. One metric is whether the government's ability to direct the SOE is limited to strategic concerns. Allowing the government to intervene in the utility's day-to-day management can compromise the utility's ability to operate as a commercial entity. On this dimension, various Canadian utilities fall short since individual ministers have extensive powers to control utility decision-making. Municipally-owned utilities such as EPCOR, however, are arguably more operationally independent relative to provincially-owned utilities (e.g. Hydro One and BC Hydro). Unlike the latter utilities, municipally-owned utilities report to the entire City council, rather than to a single minister with a narrow portfolio, and are typically not obligated to communicate on an ongoing or daily basis with its shareholder. A majority of the council are thus required to approve new directions for the utility, while for provincially-owned utilities this power resides in a single minister.

Specific reform recommendations, based on the OECD guidelines, which would enhance the governance of electric utilities in Canada are outlined on the following page.

## **Policy Recommendations**

### **i) CLARIFY THE GOVERNMENT'S ROLE AS AN OWNER**

- a) Government should establish in legislation an explicit ownership policy outlining its overall objectives, its role in corporate governance, its ownership policy implementation plans and its priorities.
- b) The government should establish in legislation that it may intervene only in strategic concerns of the utility.
- c) Utility senior management should be able to make operational decisions without obtaining prior government approval.

### **ii. STRENGTHEN UTILITY BOARD APPOINTMENT PROCESSES**

- a) Utility board members should be appointed for fixed, five year terms with renewal limited to one additional term of five years.
- b) Terms of appointment should not coincide with political election cycles and individual appointments to each board should be staggered.
- c) Utility board members may not be dismissed before the end of the term of appointment except for due cause.
- d) Candidates for board appointments should be transparently proposed by an independent entity
- e) Professional experience or qualification requirements should be established as selection criteria for utility board members. Board members should be recruited from the private sector and public sector and be independent from the government.

### **iii. CLARIFY THE RELATIONSHIP BETWEEN GOVERNMENT-OWNED UTILITIES AND OTHER PUBLIC INSTITUTIONS**

- a) The government's ownership function and other functions, such as market regulation and industrial policy, should be clearly separated to avoid a conflict of interest.
- b) Government-owned utilities and publicly-owned financial institutions should have a purely commercial relationship.
- c) The utility's liabilities should not be automatically guaranteed by the government and credit should be granted on market terms and conditions.
- d) The government's ownership function should be separated from public entities that are also clients or suppliers to government-owned utilities.
- e) Utilities should operate as commercial entities subject to normal corporate laws and regulations.

### **iv. CREATE EFFECTIVE BOARDS OF GOVERNMENT-OWNED UTILITIES**

- a) Utility boards should formulate and review corporate strategy in light of the utility's overall objectives, establish performance indicators, identify key risks, moni-

for disclosure and communication, ensure the reliability of financial statements, assess managerial performance and develop succession plans for key executives.

- b) Board members should be subject to corporate law responsibilities and liabilities.
- c) Utility boards should have the power to appoint and dismiss the CEO.
- d) The CEO and Chair should be separate positions.
- e) Appointment procedures should be transparent and CEO remuneration should be disclosed and linked with performance.

**v. MANDATE FULL TRANSPARENCY AND DISCLOSURE**

- a) Government-owned utilities should comply with the same accounting, auditing and public reporting standards as publicly traded companies.
- b) Government-owned utilities should publicly disclose material information, such as a clear statement of company objectives and their fulfillment, the SOE's ownership and voting structure, material risk factors and risk management strategies, financial assistance received from the government, commitments the government undertakes on behalf of the SOE and material transactions with related entities.
- c) Financial reports should be signed by board members and certified by the CEO and CFO.
- d) There should be clear and full disclosure of the quantitative and qualitative metrics used to measure senior executives, their performance and how their performance impacts their compensation.
- e) Large government-owned utilities should establish an internal audit function that is monitored by and reports directly to the board and audit committee.
- f) Internal auditors should develop procedures to collect information, have unrestricted access to board members and the audit committee and communicate with external auditors.
- g) Government-owned utilities should also be subject to an annual external audit.
- h) External auditors must comply with the same independence requirements followed by external auditors for private companies.
- i) The government should publish an aggregate annual report on government-owned utilities that should include an assessment of the utilities' performance and value-for-money. It should also include information on the government's ownership policy, ownership function organization, changes in utility boards and individual information on government-owned utilities. The annual report should complement, not duplicate, reporting by the utility itself.

# Participant Organizations

## **THE COUNCIL FOR CLEAN & RELIABLE ELECTRICITY**

The Council is a federally incorporated non-profit organization that was formed to provide a platform for open public dialogue and a solutions-oriented approach to the challenges of the energy sector. Representatives from universities, public and private sector business leaders, and strategic planning professionals have collaborated to broaden the public debate on energy issues. The Council has organized conferences on distributed generation, biomass, coal and nuclear, as well as on public sector governance in the electricity sector.

## **ENERGY@IVEY, THE RICHARD IVEY SCHOOL OF BUSINESS**

The Richard Ivey School of Business at The University of Western Ontario is Canada's premier business school and is recognized worldwide for the quality of its management education and research. Energy@Ivey is the centre of expertise focused on energy business issues and public policies in Canada. Its goals are to conduct and disseminate first class research on energy policy; and to promote informed debate on public policy in the sector through supporting conferences and workshops that bring together industry, government, academia and other stakeholders in a neutral forum. Energy @ Ivey draws on leading edge research by Ivey faculty as well as by faculty within the broader University of Western Ontario community.

## **THE WATERLOO INSTITUTE FOR SUSTAINABLE ENERGY**

The Waterloo Institute for Sustainable Energy (WISE) was established at the University of Waterloo in 2008 and is the focal point at UW for research in sustainable energy studies. In collaboration with utilities, private sector partners, government agencies and civil society groups, the Institute's goal is to foster the development of innovative technologies and alternatives to existing energy production and delivery systems, and to promote energy efficiency and environmental sustainability.

