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**CONSTRAINING THE EXERCISE OF
MARKET POWER IN ONTARIO ELECTRICITY MARKETS**

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Market Power of Energy Companies

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**CONSTRAINING THE EXERCISE OF
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Introduction

- In November 1997, the Ontario government released the White Paper, *Direction for Change: Charting a Course for Competitive Electricity and Jobs in Ontario*.² The paper declared bold initiatives for restructuring Ontario's electrical industry, with the goal of a competitive wholesale and retail market by the year 2000.
- As in other jurisdictions, the move to competitive electricity markets in Ontario gives rise to concerns by regulators and market participants about the existence and constraint of "market power," particularly as it relates to incumbent generators and distributors of electric power.
- This paper will consider the relevance and meaning of the term "market power" in Ontario's deregulating electricity markets, and consider areas of overlap (and potential conflict) between Ontario's new regulatory regime and the *Competition Act*.³

¹ The author is grateful for the assistance provided by Omar K. Wakil and Patrick Mousset, each associates of McMillan Bmch, with the preparation of this paper.

² *Direction for Change: Charting a Course for Competitive Electricity and Jobs in Ontario* (1997), (the "White Paper").

³ RSC 1985, c C-34, as amended.

Legislative Framework

(a) Industry-Specific Legislation

- Subsequent to issuing the White Paper, the Ontario government enacted the *Energy Competition Act, 1998*,⁴ comprised of five schedules designed to implement the White Paper's policies, including the *Electricity Act, 1998* ("Electricity Act")⁵ and *Ontario Energy Board Act, 1998* (the "OEB Act").⁶
- The purposes of the Electricity Act and the OEB Act are similar with respect to the promotion and protection of competition in the Ontario energy sector.⁷
- Each Act also contains specific references to "market power" and mechanisms to assist in the curtailment of the exercise of "market power."
For example:

⁴ SO 1998, c 15.

⁵ *Electricity Act, 1998* (being Schedule A of the *Energy Competition Act, 1998*, SO 1998, c 15).

⁶ *Ontario Energy Board Act, 1998* (being Schedule B of the *Energy Competition Act, 1998*, SO 1998, c 15).

⁷ These include: (a) to facilitate competition in the generation and sale of electricity and to facilitate a smooth transition to competition; (b) to provide generators, retailers and consumers with non-discriminatory access to transmission and distribution systems in Ontario; (c) to protect the interests of consumers with respect to prices and the reliability and quality of electricity service; and (d) to promote economic efficiency in the generation, transmission and distribution of electricity. See Electricity Act, section 1 and OEB Act, section 1.

- Section 28 of the OEB Act provides that in order to address “the abuse or possible abuse of market power” in the electricity sector, the Minister may issue, and the Ontario Energy Board must implement, directives that have been approved by the Lieutenant Governor in Council concerning market rules made under the Electricity Act and existing and proposed licencing conditions.
- Section 70(5) of the OEB Act empowers the Ontario Energy Board to impose conditions in a license “to address the abuse or possible abuse of market power, including conditions establishing minimum and maximum prices ... restricting the duration of contracts made by licensees ... [and] restricting significant investment in or acquisition of generation facilities located in Ontario.”
- The Electricity Act establishes the independent market operator (“IMO”), and gives it a clear mandate to establish rules for participation in the newly opened market.⁸ In conjunction with this mandate, the IMO must establish a Market Surveillance Panel which, among other things, may monitor and report on the conduct of a market participant.⁹
- If any report of the Market Surveillance Panel contains recommendations relating to the abuse or possible abuse of market power, the IMO must inform the Ontario Energy Board of the

⁸ Electricity Act, Part II.

⁹ Electricity Act, section 13.

review
 action it intends to take to respond to the report.¹⁰ After receiving such a report, the Ontario Energy Board also may conduct a review and may, for the purpose of "avoiding, reducing the risk of or mitigating the effects of and abuse of market power", amend the license of any market participant or direct the IMO to amend relevant market rules.¹¹

- Although the Electricity Act and the OEB Act use the term "market power", the phrase is not defined in either Act.

(b) *The Competition Act*

- As electricity markets become liberated from regulation, they become subject to general framework legislation such as the *Competition Act*.
- The *Competition Act* does not contain the phrase "market power".¹² However, the concept of market power is highly relevant to analytical frameworks employed by the Competition Bureau to assess the competitive effects of alleged criminal behaviour and reviewable business practices.
- It is important to note that the mere possession of market power or the raising of prices to supra-competitive levels by reason of the exercise of

¹⁰ Electricity Act, section 38(1).

¹¹ Electricity Act, section 38(2).

¹² The *Competition Act* is discussed more fully below.

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 market power is not subject to review and remedy under the *Competition Act*. Rather, the Act can be relied upon only to prevent the enhancement of market power (e.g. resulting from a merger) and to take action against holders of market power who engage in exclusionary or disciplinary anti-competitive acts.

What is Market Power?

- Market power is the ability of a firm, either alone or in concert with others, to profitably increase prices or reduce output above competitive levels for a significant period of time.¹³
- In a competitive market, a seller cannot profitably raise price by reducing output. This is because a reduction in output that leads to an increase in prices invites competitors to expand output and potential competitors to enter the market. Taking the selling price as given, sellers in competitive markets keep producing so long as production costs and the cost of delivering an additional unit is less than the market price.
- "Owners of electrical generators might exercise market power in several ways - for example, by strategically withholding generation from the

¹³ Ronald Binz and Mark Frankena, *Addressing Market Power: The Next Step in Electricity Restructuring* (Washington, DC: Competition Policy Institute, 1998) ("Binz and Frankena"), at page 20. See also: Director of Investigation and Research *Merger Enforcement Guidelines* (Ottawa: Supply and Services Canada, 1991) ("*Merger Guidelines*"), Part 2. This definition of market power was accepted and used by the Market Design Committee: see *Third Interim Report of the Market Design Committee to the Honourable Jim Wilson, Minister of Energy, Science & Technology* (October 8, 1998) at 17. It was also adopted by the Ontario Government: see *Fact Sheet* (Ministry of Energy, Science and Technology) (June 9, 1998).

market, by offering to supply power only at prices above competitive levels, and by managing the transmission grid to keep lower-priced power from reaching the market."¹⁴

How is Market Power Assessed?

- The starting point in assessing whether market power exists or has been abused is the identification of relevant product and geographic markets. These markets normally are defined through the use of a "hypothetical monopolist" test under which a relevant market is defined by the smallest group of products and the smallest geographic area in which a sole supplier of those products could profitably maintain a small but significant, non-transitory price increase.¹⁵
- The product dimension of relevant electricity markets will not be controversial in most circumstances (e.g. power generation). However, as noted by Binz and Frankena, determining the scope of geographic markets in the electrical power industry can be difficult, and often is the most contentious issue in assessing market power. This is because competition in electric energy markets depends on numerous factors in the relevant region including:¹⁶

¹⁴ Binz and Frankena at 2.

¹⁵ In the *Merger Guidelines*, a significant price increase usually means five percent, and non-transitory means a price increase lasting at least one year. See *Merger Guidelines* at 3.1.

¹⁶ Binz and Frankena at 37.

- capacities and variable costs of generating units;
 - demand for energy;
 - contractual limits on the amount of energy generators can sell at market price;
 - transmission charges; and
 - transmission capacity (which may vary depending upon the time of day and season)¹⁷ and whether any portion of demand in an area must be met locally to ensure system stability.
-
- Following definition of relevant product and geographic markets, an assessment is made of competitive conditions in the defined markets to determine whether market power exists or can be exercised.

 - The relevant legal test for most reviewable practices under the *Competition Act* is whether the practice has or is likely to result in a “substantial prevention or lessening of competition.” In the *Merger Guidelines*, adopted by the Commissioner of Competition under the *Competition Act* (formerly, the Director of Investigation and Research), the Commissioner expressed the view that competition is likely to be prevented or lessened if there is a likelihood that market power can be exercised or enhanced.¹⁸ The prevention or lessening will be “substantial” if the price of the relevant product is likely to be materially greater (or service levels reduced materially) in a substantial part of the relevant

¹⁷ One commentator has noted that the scope of relevant geographic markets depends almost entirely on the robustness of existing transmission systems. See L. Perl, *Measuring Market Power in Electric Generation*, *Antitrust Law Journal* (Vol. 64, 1996) at 313.

¹⁸ See *Merger Guidelines* at ¶ 2.1.

market, and the differential likely would not be eliminated within two years by new or increased competition.¹⁹

- Binz and Frankena have noted that the US Federal Energy Regulatory Commission ("FERC")²⁰ focuses heavily on market power in generation in evaluating applications for market-based pricing and for approval of mergers. Under the FERC's approach, generation market power is exercised when a company that owns generating plants brings about an increase in market prices for electric power by reducing the output of its generators or - equivalently - by raising the prices at which it offers to supply wholesale power.²¹
- The FERC issued a *Merger Policy Statement* in 1996 in which it adopted the US Department of Justice and Federal Trade Commission *Merger Guidelines* methodology for analysing the effects of mergers on market power.²² That approach is largely consistent with the Canadian *Merger Guidelines*.
- Because the ability of competitors to provide price discipline is all-important in assessing market power, barriers to enter relevant markets

¹⁹ A "materially greater" price varies from industry to industry, although the Commissioner uses five percent as a rule of thumb: see *Merger Guidelines* at ¶ 2.1.

²⁰ The FERC is the US equivalent of the National Energy Board.

²¹ Binz and Frankena at 26.

²² However, Binz and Frankena note that the FERC's methodology is inconsistent in some important respects from the US *Merger Guidelines* in that FERC uses a different and unreliable methodology - known as a hub-and-spoke analysis - to defined geographic markets. See Binz and Frankena at 37.

and the vigour and effectiveness of other competitors are all important. If barriers are low or remaining competitors vigorous and effective, an attempt to lower output (or raise price) will be met with competitive discipline from new or incumbent market participants.

- Factors such as marketplace change and innovation and the availability of substitute products and services also are relevant.
- Although often used as an indicator of an ability to exercise market power, high market share on its own does not mean that market power exists.²³ However, a combination of market concentration and entry barriers typically permits the existence and exercise of market power. As concentration thresholds increase and entry barriers rise, market power becomes greater.

How Do You Eliminate or Constrain Market Power?

- Market power can be eliminated or constrained through structural or behavioural remedies. A structural remedy contemplates some change in the structure of the market which reduces or eliminates the ability to exercise market power. Behavioural remedies, usually in the form of regulatory or rule-making oversight, seek to reduce incentives to exercise market power.

²³ It is noteworthy that Section 92(2) of the *Competition Act* precludes the Competition Tribunal from finding that a merger prevents or lessens competition substantially solely on the basis of evidence of concentration or market share.

- The most common structural remedy is the sale of all or part of a business to reduce market concentration. In electricity markets, behavioural solutions could include:
 - price caps
 - bid caps
 - vested contracts for differences
 - refinements to power pool rules
- In antitrust enforcement, structural remedies are preferred because they can be a complete fix and eliminate the need for on-going oversight.
- Binz and Frankena quote from a former director of the US Federal Trade Commission's Bureau of Competition who stated that:

A behavioural approach...has several drawbacks. First, it does not eliminate the incentive and opportunity to engage in exclusionary behaviour. Rules can try to limit the opportunity, but few rules are invulnerable to evasion. Second, detection of violations can be very difficult... Third, behavioural rules can require long-term monitoring of compliance, which can be a costly process... Fourth, it may be difficult to know whether we have selected the right rules.²⁴

²⁴ Binz and Frankena at 52.

- As discussed more fully below, the inherent weakness of behavioural remedies has been recognized by the Market Design Committee.²⁵

Market Power in Ontario Generating Markets

- The White Paper called for the separation of the monopoly operations and competitive businesses of Ontario Hydro, and indicated the government had concluded "that there is no need, at this time, to reorganize Ontario Hydro's generation assets into multiple generation companies. If an open market is approved, competition from imports and other energy sources should be sufficient to maintain discipline on prices and costs, particularly in view of the proposed reduction in Ontario Hydro surplus generating capacity".²⁶
- However, in its Second Interim Report the Market Design Committee stated that it had concluded "early on in our mandate that the decision to leave Ontario Hydro's generation assets within a single corporate entity with no constraints would be a serious impediment to developing a fair, efficient and competitive electricity generation market in Ontario, and that

²⁵ *Third Interim Report of the Market Design Committee to the Honourable Jim Wilson, Minister of Energy, Science and Technology (October 8, 1998) (the "Third Report")* at 1-3. The Market Design Committee was established by the Ontario government following release of the White Paper to provide recommendations on the design of an Independent Market Operator; propose rules and protocols to launch a fully competitive electricity market by the year 2000; and advise the government on the market rules and powers regulatory agencies would require to enforce and support the competitive market.

²⁶ White Paper at 19.

such a decision would likely result in market participants and other investors refusing to risk their capital and efforts in this market".²⁷

- Projections indicate that in the year 2000 the Ontario Electricity Generating Corporation ("Genco") will control about 85% of total electricity sold in Ontario. Five percent of the remaining 15% is under long-term non-utility generation contracts with Ontario Hydro. Demand for most electricity is inelastic (i.e., not easily reduced in the face of price increases) and barriers to enter generation markets in Ontario are significant. Given these facts, the Market Design Committee rightly concluded in its Third Interim Report that there are "serious risks that Genco would be able to exercise market power by increasing prices above competitive levels".²⁸
- To assist in its developing recommendations to address concerns about Genco's market power, the Market Design Committee surveyed solutions to market power issues adopted in numerous other jurisdictions and considered a number of other options for Ontario, including vesting contracts, contracts for differences, bid caps, required bidding curves, price caps and other similar contractual and regulatory constraints.²⁹ However, these alternatives were recognized by the Market Design Committee to be behavioural remedies which carry with them "all the usual vices of command-and-control regulation: inappropriate or perverse

²⁷ Third Report at 2-3.

²⁸ Third Report at 1-1.

²⁹ Third Report at 1-3.

incentives; public and private regulatory compliance costs; and diversion of scarce managerial talent and time to regulatory gamesmanship rather than efficient management of a commercial enterprise".³⁰

- The Market Design Committee has recommended a mixture of short-term behaviour remedies and long-term structural solutions to control and ultimately eliminate Genco's market power. These include:
 - Subjecting Genco to a price cap and consumer rebate regime for at least the first four years of the competitive market. Under this proposal, Genco would receive no more than 3.8 cents per kilowatt hour for electricity generated. The ceiling ensures that, together with any transmission charge, consumers will pay no more than the current pre-competition average retail price of 7.2 cents per kilowatt hour. If the average spot market price exceeds 3.8 cents at any time, Genco would be obliged to pay a rebate to all Ontario wholesale customers on most of its volume.
 - Obliging Genco to reduce its "tier two" generation capacity (that is, essentially, all price-setting generating capacity other than nuclear and hydro-electric) to no more than 35%³¹ within 42 months of the market opening. Concurrently, the Ontario Electric Services Corporation would be obligated to commit to increasing

³⁰ Third Report at 1-3.

³¹ The 35% threshold reflects the threshold adopted in the *Merger Guidelines* for unilateral exercise of market power. Under the *Merger Guidelines* approach, it is presumed, absent evidence to the contrary, that market power cannot be exercised if less than 35% market share is held: see *Merger Guidelines* at ¶ 4.2.1.

inter-tie capacity with neighbouring jurisdictions, thereby intensifying competition from-out-province generators.

- Requiring Genco to reduce its market share of total generating capacity serving Ontario demand for electricity to no more than 35% within 10 years.³²
- Prohibiting Genco from acquiring more than 35% of firm long-term in-bound transmission capacity rights.
- These measures should ensure that Genco could not exercise market power after year ten. However, during the interim period Genco's activities will be subject to scrutiny by market regulators, including the Ontario Energy Board and the Competition Bureau.

Regulatory Oversight: By the Ontario Energy Board

- The White Paper contemplated that a newly invigorated Ontario Energy Board would be responsible for promoting the development of competition in generation and retail services and stated that "the Board would have an important role in ensuring that market participants do not abuse market

³² Genco would be precluded from transferring capacity to any person who, as a result of the transaction, would hold more than 25% market share. Transfers which could facilitate "interdependent behaviour" also are precluded. Interdependent behaviour refers to conduct of a group of firms that is profitable for each of them only because of the co-operative conduct of others. The behaviour may result from tacit or explicit arrangements or agreements. As a rule of thumb, interdependent behaviour is thought unlikely to occur unless the four largest firms in the relevant market have 65% market share, and the firm(s) in question has market share of 10% or more.

power or engage in anti-competitive pricing or other monopolistic practices. In this regard, it would have responsibility for ensuring the licensing of all agents, brokers, marketers and generators participating in the market".³³

- Under the OEB Act, the Ontario Energy Board has a positive obligation to monitor markets in the electricity sector, and prevent abuses of market power. It may report to the Minister of Energy, Science and Technology on the efficiency, fairness, transparency and competitiveness of those markets.³⁴
- The Board's "stick" is exercised through the terms that it may impose in operating licenses which all market participants must obtain from the Board.
- The Board also has provincial authority to review and approve certain mergers, amalgamations and dispositions involving transmission and distribution assets.³⁵
- The OEB Act requires the Board to refrain, in whole or part, from exercising any power or performing any duty under the Act if it finds that "a licensee, person, product, class of products, service or class of services is or will be subject to competition sufficient to protect the public

³³ White Paper at 19.

³⁴ OEB Act, Section 87(1).

³⁵ See OEB Act, Sections 80 to 86 (especially 80 and 81).

interest".³⁶ This can be referred to as the Ontario Energy Board's "Forbearance Power."

- Section 29(3) of the OEB Act provides that "for greater certainty," where the Ontario Energy Board exercises its Forbearance Power, "nothing in this Act limits the application of the *Competition Act (Canada)* to those matters with respect to which the Board refrains".

Regulatory Oversight: By the Competition Bureau

- The *Competition Act* is federal legislation that applies to all businesses in Canada, including federal and provincial Crown corporations in respect of commercial activities engaged in by those corporations in competition, whether actual or potential, with other persons.³⁷
- The *Competition Act* contains a mixture of criminal offences, discretionary reviewable practices and private damage actions. Prosecution for criminal offences such as conspiracy, bid-rigging and price discrimination are brought before criminal courts where cases must be proven beyond a reasonable doubt.
- Non-criminal "reviewable practices" include mergers, abuse of dominant position and vertical market restrictions such as tied selling. Reviewable practices that result in a substantial lessening of competition are subject to

³⁶ OEB Act, section 29(1).

³⁷ *Competition Act*, section 2.1.

restraint and corrective action by the Competition Tribunal, the specialized adjudicative body for non-criminal antitrust matters.

- The Commissioner has exclusive statutory responsibility for the administration and enforcement of the *Competition Act*. He is assisted in this task by staff of the Competition Bureau. The Commissioner alone has the authority to investigate breaches of the Act and to initiate proceedings which involve reviewable practices. The Competition Tribunal has no independent authority to act.
- The Commissioner also has a mandate to provide input to federal and provincial agencies "in respect of competition".³⁸
- The *Competition Act* does not contain a forbearance provision analogous to section 29 of the OEB Act which would permit the Commissioner to refrain from taking action against any particular industry sector or in respect of any particular behaviour otherwise caught by the Act.³⁹

³⁸ *Competition Act*, sections 125 and 126.

³⁹ However, a "regulated industries defence" has been developed by Canadian courts under which conduct that is specifically authorized or directed by legislation or regulation is immunized from enforcement action under the *Competition Act*. George Addy, the former head of the Competition Bureau, succinctly described the defence as follows:

The gist of the regulated conduct defence is that specific activity which is authorized or carried out pursuant to a valid scheme of regulation is deemed to be in the public interest. As such, it cannot be found to be in violation of the criminal provisions of the Act. There is no similar jurisprudence with respect to the civil provisions of the Act and it remains for the courts and the Competition Tribunal to determine the full scope of the application of the Act

See George Addy in Speeches and Addresses, *CompAct* (22 May 1996) (available online at <http://strategies.ic.gc.ca>).

The Potential for Regulatory Duplication

- To the extent that the Ontario Energy Board exercises its Forbearance Power or does not have legislative authority to regulate, the *Competition Act* will apply and the Commissioner will enforce the Act without duplicating the Board's efforts. Conversely, competition law will have no application in industry sectors that continue to be regulated (e.g. transmission and distribution).

- However, there are numerous areas in which both the Board and the Commissioner have legislative authority to act and the potential exists for duplication of roles and responsibilities. Areas of overlap include:
 - mergers
 - abuse of market power
 - false or misleading advertising
 - collusive conduct
 - price discrimination and other pricing practices

- In a recent speech, the head of the Competition Bureau's Civil Matters Branch expressed the view that even from the first opening of formerly regulated markets, competition law should be relied upon to prevent anti-competitive business practices unless regulation is demonstrably better in this role (e.g. monitoring and preventing use of market power to increase prices).⁴⁰ However, he also observed that measures should be adopted to

⁴⁰ André Lafond, Deputy Director of Investigation and Research, Civil Matters Branch, Competition Bureau, "The Role and Responsibilities of the Industry Regulator Versus the Competition Bureau as Regulated Industries Become Competitive" (Address to

effectively coordinate the roles of the Competition Bureau and the regulator where there is overlap. Such measures would be designed "to clarify each organization's roles and responsibilities [without either organization giving up jurisdiction], help coordinate interventions in the relevant sector, minimize overlapping or duplicative investigations and remedies, and create a more certain competitive business environment".⁴¹

- In its final report, the Market Design Committee issued a set of proposals designed to enhance coordination of the roles of the Ontario Energy Board and the Competition Bureau.⁴² The proposals were developed following meetings attended by representatives of the Market Design Committee, the Ontario Energy Board and the Competition Bureau.⁴³ While the Commissioner has not formerly adopted the proposals, senior Competition Bureau staff are supportive of them.
- If adopted in the form proposed, the activities of the Board and the Competition Bureau would be coordinated as follows:
 - *Notification:* Subject to statutory confidentiality constraints, each regulator would commit to informing the other of complaints

The Conference Board Regulator Reform Program Meeting, 19 February 1999) "Lafond" [unpublished] at 6.

⁴¹ Lafond at 9.

⁴² See *Final Report of The Market Design Committee to the Honourable Jim Wilson, Minister of Energy, Science and Technology* (January 29, 1999) (the "Final Report"), Exhibit H.

⁴³ Final Report at 2-12 and 2-13

received or issues uncovered which potentially raise issues under the other's legislation or mandate.

- *Consultative Coordination:* Where overlapping jurisdiction exists, the regulators would engage in early consultation with respect to investigations and imposition of remedies or fines.
- *Licensing Restrictions:* The Competition Bureau would provide competition-related input and analysis to the Board in its licensing reviews and proceedings.
- *Mergers:*
 - the principal responsibility for dealing with vertical market power and access concerns pertaining to transmission and distribution mergers would rest with the Board. The Competition Bureau might intervene in Board proceedings and provide input into the process.
 - In its review of mergers involving transmission and distribution companies, the Competition Bureau would take into account actions and views of the Board.
 - The Board and the Bureau would consult to minimize duplication and overlap in their respective review of other mergers. In its assessment, the Board is to take account of

the Competition Bureau's conclusions regarding the likely competitive effects of a proposed merger.

- *False or Misleading Advertising:* As a general principal, the Board would take a leading role in preventing and disciplining false or misleading advertising by setting and enforcing related licensing provisions.
- *Collusion, Price Fixing and Bid-rigging:* Although the regulators would have shared responsibility, cases would be referred to the Competition Bureau for investigation and prosecution under the *Competition Act*. Additional measures and remedial action also could be taken by the Board or the IMO.
- *Unilateral Market Power Control and Mitigation:* These matters would be the responsibility of the Board since the mere possession of market power and its exercise to raise prices typically is not subject to control or corrective action under the *Competition Act*.
- *Other Competitive Abuses:* The Board is to be principally responsible for preventing other competitive abuses and exclusionary practices through its licensing authority.

Importantly, the jurisdiction of the Ontario Energy Board and the Competition Bureau would not be restricted.

- This approach to informed coordination of regulatory oversight by the Competition Bureau and another regulator is novel and unprecedented. It should enhance predictability of relevant processes, but will not immediately result in regulatory forbearance by either agency.

Conclusions

- The exercise of market power is not desirable and should be constrained. This is recognized in the proposed new regulatory regime governing Ontario electricity markets.
- The application of market power concepts under the *Competition Act* and in other jurisdictions should inform the Ontario Energy Board in its deliberations on market power issues.
- De-regulation of Ontario electricity markets will immediately result in duplicate oversight by the Ontario Energy Board and the Competition Bureau.
- While these agencies likely will co-ordinate on procedural matters and in some circumstances defer to each other's areas of specialization, market participants will need to deal with both agencies to the extent that their activities are governed by or subject to Ontario's new electricity legislation and the *Competition Act*.