



# Ontario's Water Utilities: Governance Models

a report prepared for the

Ontario Municipal Water Association (OMWA)

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 cooperation with the Ontario government, the Ontario Clean Water Agency (OCWA) and other water authorities.

Angus Read  
*President*

Don Black  
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A report prepared for the

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## Part 1. Executive Overview and Introduction

As they enter the next century, Ontario's water utilities are facing a new challenge over the nature of their governance. The governance issue presents itself at this time for OMWA's members mostly as a result of the Harris government's program of municipal restructuring, but also because of pressure on all governments to introduce competition into the utility industry wherever possible.

*The main vehicle for reviewing the governance of water utilities is the sweeping new flexibility of the Municipal Act to undertake municipal and utility restructuring.* This flexibility is receiving widespread use by municipal councils. Whether the outcome is arrived at through the options now available for locally-driven restructuring initiatives or provincially-appointed restructuring commissioners, the result can be a dramatic remaking of a municipality and, in this case, the services provided by its water utility.

While the legislative amendments that make municipal restructuring readily possible create the visible pressures for change, an underlying pressure also results from the restructuring of the utility industry in Ontario and beyond. This is occurring through the advocacy by government and the private sector for *competition in services that can be subject to the marketplace and contestability in the provision of monopoly services.* Contestability means that, while the services are a natural monopoly function, there should be a competition for who can be the monopoly provider. This concept promotes and encourages "alternative service delivery," which is the new phraseology for franchising.

Ontario's water utilities will need to be positioned in a governance arrangement appropriate to utility services if they are to carry on their record of past accomplishments in the service of their communities. This will be the case no matter what else is determined by the local governments or the commissioner in the restructuring endeavour. *The purpose of this report is to lay out all the options and factors that may go into that governance selection and provide arguments in defence of the options in order to enable OMWA members to make informed recommendations on utility matters in the restructuring initiatives they face.*

To this end, Part 3 of this report, the core component, will be devoted to a critical appraisal of the five main governance options available in water utility restructuring:

- utility department operated by municipal council
- utility commission appointed from council by council
- utility commission appointed from public by council
- utility commission chosen by municipal electors
- utility franchise awarded by municipal council

While commissions may be the preference of the water utility sector over departments for business autonomy reasons, this is no longer an either/or choice. As the above options indicate, there are now three types of commissions available in municipal restructuring. Moreover, the council has much greater flexibility to convert commissions to departments and award franchises. For these reasons, *this report will analyse the options on a linear range of council control and business autonomy, with the*

*council department and private franchise at opposing ends.* For comparative purposes, the analysis will review the background, strengths and weaknesses of each option, followed by observations.

Before proceeding to this analysis, Part 2 of this report will examine the new policy framework that is shaping municipal and utility restructuring. What may not be apparent on first glance is that *municipal and utility restructuring actually overlap in a significant fashion.* This occurs through the Harris government's program of *provincial/municipal policy disentanglement.* It has implications for the local water utility sector for two reasons. The first is that disentanglement has directed the government's municipal reform objectives, specifically the need to create larger and stronger municipal governments that can absorb roles until now provided by the province. Second, disentanglement has guided the government's withdrawal from direct ownership of water and sewage facilities on behalf of municipalities.

While a detailed examination of this new municipal and utility policy framework is not provided in this report, one can be found in the earlier OMWA report entitled, *Ontario's Water Industry: New Legislative Framework*, (prepared by Neil Freeman and dated April 21, 1997). In that report, an assessment is provided of the character and impact of the five major government initiatives that are reshaping the governance and operation of the municipal and municipal utility sector:

- Bill 26 amendments to the *Municipal Act, Public Utilities Act and Municipal Franchises Act*
- Crombie "Who Does What" Committee recommendations
- Bill 86 amendments to the *Municipal Act* and the *Municipal Elections Act*
- Bill 107, *Municipal Water and Sewage Services Transfer Act*, amendments to OCWA
- 'White Paper' proposal on 'natural person' governance framework for the *Municipal Act*

When the factual content of the earlier report is read in conjunction with the governance considerations in this report, a complete picture is presented for the *restructuring and governance challenges* facing Ontario's water utilities.



## Part 2. New Municipal Policy Framework

The new municipal policy framework has been established by the Harris government with two main objectives in mind. The first is *provincial/municipal policy disentanglement*, which is intended to remove overlap and duplication in the provision of services by the two levels of government. The second, *municipal governance reform*, is designed to give municipalities the flexibility to restructure their boundaries and services to provide more efficient and effective government.

In order to put the new policy framework in place, the Harris government has passed two major pieces of municipal legislation and has circulated a 'white paper' proposal for a new underlying philosophy for the *Municipal Act*. (All three are discussed in detail in the earlier OMWA report entitled *Ontario's Water Industry: New Legislative Framework*). For water utilities, the main impact of the first piece of legislation, the **Bill 26** omnibus package of amendments, was to give municipal governments simple and easy to use rules for restructuring. The second, the **Bill 86** omnibus amendments, continued from the lead of the first by removing any requirement for "assent of the electors" before councils made changes to the existence of utility commissions. The 'white paper,' which is not yet legislation, anticipates giving municipal councils the powers of a 'natural person' to enable them to contract for services like any other business.

### 2.1 Provincial/Municipal Policy Disentanglement

The objective of provincial/municipal policy disentanglement is one of the main reasons the 1995 provincial election can be seen as a *public policy watershed* in Ontario's history. The policies of the Harris government are very much guided by the view that government is too intrusive in the economy and does not claim to have the answers for all societal problems. *This position reflects a commitment to smaller and less activist government, all of which is having a profound impact on the administration of provincial and local services.* For the most part, the public now accepts the contention that government at all levels is not always efficient and cost effective.

To get its own house in financial order, the provincial government has decided to reduce dramatically the amount of its financial transfers to individuals, institutions and other governments, including municipalities and their water utilities. *The guiding philosophy is that the government responsible for the service should be responsible for the full cost of its financing.* Only in this structure is it believed that the taxpayer, or the ratepayer in the case of water utilities, can have confidence that public funds are being expended wisely and that those making the decisions are publicly accountable. Achieving this objective requires assigning the full cost of services to the users of the services, wherever possible, as a matter of principle.

On the municipal governance and services front, this new policy framework has driven a government-wide agenda of disentangling responsibility for provincial and municipal services. Although it is the original user-pay public service, with little or no dependency on municipal or provincial taxes, the

local water utility sector is nonetheless at the junction of two significant provincial government disentanglement initiatives.

The first is David Crombie's "**Who Does What**" Committee, appointed by the province to sort out new provincial and municipal roles. The recommendations of this committee, which for the most part have enjoyed the support of the Ministry of Municipal Affairs and the Association of Municipalities of Ontario (AMO), have led to major amendments of the *Municipal Act*, the *Public Utilities Act* and other municipal statutes. The second is the government legislation, **Bill 107**, the *Municipal Water and Sewage Transfer Act*, that has already ended the provincial ownership stake in the water and sewage industry, with the province's assets to be passed to the municipalities they serve.

Since local water utilities are at the juncture of these initiatives, their future is dependent on more than the policy developments in any one initiative. Indeed, the Ministry of Municipal Affairs and Housing and the Ministry of Environment (now without Energy) both have a role in the restructuring of the local utility sector. But in this *overlapping responsibility* there is the basis of an orderly division of responsibility. As long as local utilities have a municipal governance component, Municipal Affairs is the lead ministry on governance matters. In such a scenario, the Ministry of Environment is the lead ministry only on water and sewage operational issues.

## 2.2 Municipal Governance Reform

The unique feature of the recent reform of the municipal governance framework in Ontario is that municipal councils are being empowered to be the *near sole point of contact* with the provincial government for the affairs of their municipality. Until now, provincial-municipal relations were fragmented or fractionalized, with different provincial ministries, agencies, boards, commissions and corporations, on the one end, having direct relations with the council or various autonomous boards and agencies at the other, depending on the policy. While some fragmentation will continue, such as in the case of policing, the *policy and financial control of the municipal councils over utility matters has been enhanced*.

The chief objective of the provincial government in municipal restructuring is to establish larger and stronger municipalities. Disentanglement demands this outcome. *For the province to reduce its role in what are now being determined to be municipal responsibilities, the municipalities must have the administrative competence to absorb the downloading of the roles the province may until now have provided*. Although the province in many cases assumed these roles to control policy, in other cases it did so to ensure the services were provided. Now that the province has backed out of the financing of many of these programs, the municipalities are expected to fill the vacuum. In the end, the province, by reducing its financial obligations, has reduced the legitimacy of its role in determining local policy. The price will be municipal consolidation and may possibly be higher municipal service costs. However, the objective is to have costs financed by service users rather than the consolidated revenue fund of the province.

While under other political circumstances the municipalities of the province might have been expected to resist the downloading policy of the Harris government, this did not happen in this case. Even before the government was elected, the Association of Municipalities of Ontario recognized that the *past was no longer economically sustainable*. For this reason, AMO participated in the government initiative, but in exchange for two very significant return favours. First, the municipalities have received a much *greater degree of operating freedom* from provincial policy direction. Second, the province has made the municipal council the *pre-eminent local authority*, bringing to an end the fragmentation that had existed in provincial-municipal relations. In the result, the plethora of autonomous local agencies, boards and commissions have either been brought under council control or have had the basis for their autonomy diminished.

With this backdrop to the task of restructuring, municipal councils have extraordinary flexibility to initiate major boundary changes and alterations to municipal services. The Bill 26 amendments to the *Municipal Act* allow municipalities to restructure on the basis of a *triple majority* – a majority of the upper-tier council, a majority of the lower-tier councils, with the proviso that the lower-tier councils represent a majority of the affected population. Through this *locally-driven process*, the municipalities involved submit a restructuring proposal to the Minister of Municipal Affairs for approval. The Minister can then sign a restructuring order into law, with the whole initiative taking as little as a matter of months. In the event the local municipalities cannot come to agreement, one or more of them can apply to the Minister for the appointment of a restructuring commissioner. Although this *provincially-driven process* permits local input, it removes the local decision-making control because the commissioner's order is final.

The power to alter services came first through the Bill 26 provision for “service migration,” which allows municipalities under the triple majority, locally-driven process to move services between upper and lower tiers of municipal government. Second, the Bill 26 and 86 amendments to the *Municipal Act*, together, *now give municipal councils the power to dissolve autonomous water utility commissions*, or take water out of public utilities commissions, simply on the vote of the council, and the council can create a franchise for such a utility service on the same basis.

As these scenarios suggest, the local utility services will be affected greatly by a restructuring order. First, the affected utilities will be mapped to the new municipal boundaries, and could be placed at the upper tier in two-tier municipal structures. Second, water utilities that are presently part of commissions face no impediment to council takeover. Moreover, both water commissions and departments can readily be made subject to “alternative (or non-municipal) service delivery,” even though this option removes the formal avenue for customer voice in management through municipal officials.

### **2.3 New Municipal Terminology and Definitions**

Before proceeding to Part 3, there are new terms and definitions that must be clarified for the discussion in this report to be fully comprehended. First, all the traditional distinctions that used to exist between a city, town, village, township, county, and region have now been abolished, with

municipalities given the new freedom to call themselves whatever they choose. Second, all municipalities now fall under the general categories of upper-tier, lower-tier and single-tier. Two-tier municipalities are regions and counties, with counties being generally distinguished from regions by not representing the cities and the separated towns (single-tier municipalities) within their boundaries. Northern districts are not upper-tier municipalities. Third, a “local municipality” is a lower-tier or a single-tier municipality. Fourth, a single or multi-function public utility commission is a “local board”. This is defined in the *Municipal Affairs Act* (for all the other pieces of legislation, including the *Municipal Act* and the *Public Utilities Act*), specifically to include elected and appointed commissions or PUCs.

### Part 3. Municipal Utility Governance

In considering the range of models for water utility governance, the choices available are differentiated by the appropriateness of their *measure of business autonomy and political control*. In Ontario, municipal functions and services are performed either by the municipal council directly or by a "local board", save for cases where services can be and are contracted out to franchise operators. There are some functions, like policing, that must be operated by local boards, and there are others like water that can be operated by either council or commission (by statute a "local board") or franchise.

From this statutory environment, which can be found in the *Public Utilities Act* and the *Municipal Franchises Act*, there are five basic options available for utility governance. A municipal restructuring initiative can choose to put utilities in a utility:

- (1) department operated by the municipal council,
- (2) commission appointed from council by the council,
- (3) commission appointed from the public by the council,
- (4) commission chosen by municipal electors, and
- (5) franchise awarded by municipal council.

In the sections in this Part which follow, the five options will be reviewed in this order for their background, strengths and weaknesses. *This order has been selected because it reflects a linear range from the most council control to the most business autonomy, and serves as an illustration that departments and franchises are the extremes of this dichotomy of autonomy and control.* For this reason, the ordering does not reflect a preference of options, but rather a tool for evaluation of the strengths and weaknesses of options that may be being considered locally.

Before proceeding, it is worth noting that water utilities are not like other municipal services in that they have, to a large degree, a *distinct function* that, while part of the municipal service environment, is for the most part a *self-contained business*. Moreover, water utilities are distinguished from other municipal services in that they are financed by ratepayers rather than taxpayers, and are not generally part of municipal budgets. Thus, *while water utilities can be run by council, there are reasons why this may not be the best situation in a large number of municipalities.*

One reason for considering the full range of options is that while all water utility ratepayers are municipal taxpayers, they use utility services in different quantities. Moreover, they do so on a *cost-of-service* basis. This user-pay arrangement has meant that care must be taken in deciding on a utility governance model because an important *supplier-customer business relationship* is a stake. *In such arrangements, business and other consumers have historically expressed a preference for utility matters to be removed from the politics of municipal government.*

### 3.1 Department Operated by Council

#### 3.1.1 Background:

From the origin of the *Municipal Waterworks Act, 1882*, municipalities have had the option of running water utilities under the structure of a department of the municipal council or through an autonomous commission created by the council. The passage of the *Public Utilities Act, 1913*, reconfirmed this basic option, which has persisted to this day. *This option would create the greatest degree of political control and the least amount of business autonomy.*

Over time, there has been an increasing strength to the administration of the municipal governments of the province, a situation that will be augmented with the passage of the permissive 'natural person' governance framework. *The result will be stronger municipalities with a desire to have greater control over all municipal functions*, removing the general bureaucratic fragmentation that has existed at the local level. The official position of the Association of Municipalities of Ontario on this issue is that councils should have complete freedom to organize their functions as they please, that is free from prescriptive provincial rules. In the case of water utilities, which have autonomy in many municipalities, this is a not so subtle message that means greater council control.

#### 3.1.2 Strengths -- Departments:

The advantages of having water utilities organized as municipal departments stem from the municipal council having direct control over all or most municipal services. In the result, *there is only one political and administrative structure and no rival municipal authorities*, at least for utility operations.

The principal political justification for this structure of water utility governance is accountability to the municipal electorate. If local government is to be effective, adherents of this view hold, *local democracy should not be divided or fragmented between local authorities*. In municipalities that have utilities with autonomy from council, some councillors complain that they are still held politically responsible for utility issues, although utility commissioners will have a different view. The reasons councillors give are that the public does not separate the lines of accountability or the customer complains to the council when satisfaction is not received from the utility. If utilities operate as departments, so the logic goes, electors have only one set of politicians to choose from on election day and know who to hold accountable between elections.

A related political issue is that councils resent the autonomy of local boards to expend public funds, because the council is the local body that is held accountable. This is especially the case in instances where autonomous boards, whether they be for water utilities or public libraries, are spending municipal tax dollars. In cases where an autonomous local board such as a utility has its own revenues and is self-financing from its own revenues, the argument is not as persuasive as it is in the case of libraries, although the latter have their own reasons for autonomy.

This political justification for department-run utilities has an administrative equivalent. With water utility functions under the council, there is only **one municipal hierarchy**, with all employees under the direction of the municipality's Chief Administrative Officer. This makes it possible for **efficiencies of scope** in the administration of the utilities and **efficiencies of scale** in the municipal administration. For starters, there are potential efficiencies in the core administrative functions of billing and collection, human resources, and the like. In addition, there are potential efficiencies from combining municipal engineering, planning and accounting functions with those of the utilities.

The political and administrative justifications overlap in the possible financial benefits. With the utilities operated as a municipal department, there is only a single municipal budget. The chief advantage that results is the flexibility this provides for the council. *The council has a greater degree of control over all municipal revenues and expenditures*, both in their volume and in any debt obligations. The council, through the single budget, has the *discretion to manage the finances of all municipal services, including mixing utility surpluses with municipal taxes*. This permits the council, in effect, to cross-subsidize municipal services from utility rates, or the reverse. It also permits the municipal 'bonusing' of industry with utility rates and municipal taxes.

### 3.1.3 Weaknesses -- Departments:

The weaknesses of having water utilities operate as municipal departments is that the council's direct control over all municipal services can *lead to insufficient attention being devoted to the needs of the utilities*. While this would be true of any municipal service falling under a council, the operation of utilities differ for a very important reasons. *Utilities require long-term planning for renewal and for meeting water quality and health standards* that can suffer by being subjected to the vagaries of municipal politics and the municipal electoral cycle. As an example, utility expenditures lack the visibility and public appeal of parks and recreation expenditures.

Municipal councils face many competing objectives in the performance of their functions. And, as councils increase their responsibilities under the new municipal governance framework, and the number of the councillors shrink through restructuring, *the ability of the council to devote attention to all issues may be even less than has been the case in the past*. This can lead to decision-making overload and policy paralysis. The consequence is that important business matters are not attended to when required. Where the water utility may have a project requiring approval for implementation, the council agenda may stand in the way of it receiving due consideration.

This is a problem for the water utility operation because *utilities need to be responsive to rate-paying customers, not just taxpayers*. For this reason, the traditional argument for bringing autonomous municipal functions, such as library boards, under the control of the council do not apply in the case of utilities. Water utilities are the original user-pay public services. When organized as they should be with *dedicated revenues for operation and renewal*, they do not expend municipal tax dollars. This financial autonomy negates one of the principal justifications for municipal councils to have policy control over the operation of utilities. Utilities do not spend council tax dollars.

It is also the case that *council politics can stand in the way of sound water utility management*. In the provision of utility services, customers expect that their rates will be applied to operational and capital expenditures in a manner that provides the lowest cost of service and the greatest efficiency in operation. If the council has the ability to use utility revenues for other than utility purposes, the business basis of the utility is undermined and its policy enters the realm of political considerations unrelated to sound utility management.

A related problem is that the water utility, caught as it can be in the competing objectives before the council, may be subjected to political calculations that do not serve its long-term interests. Municipal politics, which generally does not operate with parties, is characterized by the phenomenon of 'logrolling,' which means winning vote support through political bargaining and tradeoffs. The result can be that *utility decision-making can be subjected to the self-serving political considerations of individual politicians*.

Even where water utilities are not subject to political calculations, the efficiencies that councils claim or seek by having utility administration merged with municipal administration may not appear. While these efficiencies are possible, *there is also the potential for diseconomies and inefficiencies from scale, depending on the case*. Moreover, on a business case basis, the demands of operating the municipal administration may in fact lead to functional separation of, for instance, human resources, by major municipal department. The same is true for scope. The advantages of moving to centralized accounting and a single budget can work at cross-purposes with sound utility administration.

Being business operations, not just services, *water utilities need to operate on an industry standard basis*. When they are brought into a municipality-wide budgeting and accounting framework, the needs of the council are satisfied through the uniformity of procedure, but the needs of the utility may suffer. Utilities are best operated on a '**full-cost accounting**' basis rather than a **municipal accounting** basis. This allows for *proper benchmarking with other utilities as opposed to other municipal services*, where the comparisons would be less meaningful. This problem will be exacerbated under a competitive environment for utility services because the utilities will need to adapt rapidly to changing business conditions and risks. Moreover, the alternative service delivery providers will not face this constraint, and thus will have more business flexibility. If utility accounting is merged with the municipal, the fit can only be inexact, with the perceived efficiencies possibly lost in the extra work required to keep the full-cost accounting system running parallel.

### 3.1.4 Observations -- Departments:

Operating water utilities as municipal departments has advantages in both small and large municipalities. In the small ones, the political, administrative and financial reasons are all very compelling. In the large municipalities, the advantages primarily are derived from economies of scope and scale. However, given the self-contained nature of utility operations and the need for them to operate administratively and financially with *de facto* autonomy, there will possibly be diseconomies from the command and control structure of the municipal department option. The weakness, then, of the departmental model is that *the distinction between the utility ratepayer/customer and the*



*municipal taxpayer/citizen can be overlooked or not kept as a foremost consideration in municipal administration.* While this may matter little to many citizen-taxpayers, it will be a concern of particular interest to business customers of utility services. The reason is that, under competition in the delivery of the services, utility rates and practices will be critical to retaining and attracting industry. Municipalities can run the risk of being less than business friendly if utility services get caught up in council politics.

### **3.2 Commission Appointed by Council from Council**

#### **3.2.1 Background:**

The option of a water utility commission appointed from council is a hybrid arrangement that is presently available only in the context of a municipal restructuring initiative. It has been made possible through the recent Bill 26 and Bill 86 amendments to the *Municipal Act*. The hybrid nature results from the commission having a *separate corporate existence from the municipal corporation, but interlocking governance through appointments from council*. The result, in effect, is that the commission is operated by a *de facto* committee of council. For these reasons, the commission selected from council option can have the *political and administrative advantages of a department structure*. While it can also operate with corporate autonomy, the council governance means this is less likely to occur in practice.

Although there has been an option for appointing commissions in the case of electricity for some time (see the next option), the general provisions have never included appointment of the commissioners from council, save for the mayor *ex officio*. The reason is that commissions, elected and appointed, were made an option precisely to remove them from direct control by councillors. The recent amendments to the *Municipal Act*, however, have removed this requirement. *In this option, the degree of political control versus business autonomy does not differ much from that of a utility run as a department.*

#### **3.2.2 Strengths -- Council Run Commissions:**

The chief strength of the commission appointed from council option is that it can have all the advantages of a municipal department (noted in the previous section) for the council even though it is in law a separate corporate business entity. In this manner, the utility can meet the legal requirements for autonomous operation while falling under the political direction of councillors. As a result, the potential for competing objectives between the council and the commission is removed, as the commission is clearly accountable to the council.

Like a department, *this option permits the municipality to merge the administration of the municipality and the utilities for efficiencies of scale and scope*. The council is able to control all planning and financial matters, including integrating the utility budget into the municipal budget. While this permits the municipality to cross-subsidize municipal services with utility rates rather than

finance them out of taxes, the commission may also be run with full-cost accounting and dedicated revenues for renewal. The decision depends on the will of the commissioners (councillors) and any statutory constraints or regulations.

### 3.2.3 Weaknesses -- Council Run Commissions:

The weaknesses of the commission appointed from council model all stem from the fact that the utility has only the *appearance* of business autonomy from the municipality. The commission, which is organized in law as a separate corporate entity to allow it business autonomy from the council, has the *competing objectives of the council superimposed on it through councillors serving as commissioners*. This can make the commission a *de facto* department of the municipality. While this will seem appropriate to many, water utilities will nonetheless operate in increasingly demanding quality and competitive business environments for which they will need a degree of decision-making responsiveness that is not often available in council matters.

Water utilities also differ from councils in that their planning needs are, for the most part, longer term. The result is that *utility commissions need continuity of service by commissioners* who have a focus on the quality and business matters at hand. Councillors appointed as commissioners present two potential problems to utility leadership. The first is that the councillors' range of political concerns is much broader than the needs of the utility. The second is that water utility issues become part of the political calculations that are municipality wide. The result is that *council politics is transferred to the water utility, with utility business issues caught in the political trade-offs that are endemic to building support for council initiatives*.

The entry of council politics into the operation of the water utility is an illustration of the extent to which the commission is accountable to the municipality rather than the utility customer. This is a difficult situation for the *commissioners because they have or need to have dual loyalties*. Given the corporate nature of the commission's legal status, the commissioners should have a business obligation to serve the best interests of the utility. *That the commissioners are also councillors means that their business autonomy is compromised*. While an argument can be made that a council operating a utility department does not have the same problem operating both, the pretense that the utility is autonomous from the council does not exist. Commissions differ in that they are, in business terms, customer cooperatives that happen to be owned by the municipality.

Although in theory the council could operate the commission with autonomy from the municipality, the implementation of the commission appointed from council model precludes this outcome. The reason is that the current practice in municipal restructuring in Ontario is to maximize the integration of municipal and commission operating functions. Indeed, *many municipalities seek to bridge the administrations by making the municipality's Chief Administrative Officer the general manager of the utility commission*. Such a dual responsibility for the CAO would for all practical purposes submerge utility autonomy under a single municipal administrative hierarchy.

### 3.2.4 Observations -- Council Run Commissions:

The attractiveness of the commission appointed from council option is that it allows the council to maintain the appearance of an autonomous commission while running the water utility as a department of the municipality. The option would not be desirable or utilized were not there a current requirement for electric utilities to be run by commissions. In the long run, *this option is not likely sustainable because it is fraught with problems that result from it being neither department or commission*. For this reason, it is an option that may cause problems where it is implemented. The attractiveness of the option could dissipate if the requirement for operating electric utilities through commissions is removed through electricity restructuring.

## 3.3 Commission Appointed from Public by Council

### 3.3.1 Background:

As noted above, the commission form of water utility governance originated in the 1880s, but the option of appointing commissions actually began much later. It arrived in 1915, following a conflict between Ontario Hydro and Toronto Hydro, but only applied to water utilities that were part of public utilities commissions that also distributed electricity. This came about through the amendment of the *Power Corporation Act* -- the legislation governing Ontario Hydro and its relations with municipal electric utilities -- to permit municipalities with greater than 60,000 people to have an appointed commission. The appointment criteria, however, remains very strict, limited to the mayor or head of council *ex officio*, a council appointee and an Ontario Hydro appointee. Two points are notable on this formula. The first is that the council appointee cannot be from the council. The second is that the provision for the Ontario Hydro appointee will not likely survive the transition to electricity competition.

The exceptions to the *Power Corporation Act* criteria used to be just those municipalities or utility commissions that are established under special legislation, and thus have the appointments scheme written into the individual statute. But now, under the auspices of a restructuring commission or study, there is more flexibility than previously permitted. The Bill 26 amendments to the *Municipal Act* create a new authority for appointed commissions. It is now possible to design an appointed governance structure that is tailored to the requirements of the municipality. *This option provides better balance between political control and business autonomy, but is weighted more to the former by the fact that the commissioners owe their appointment to the council.*

### 3.3.2 Strengths -- Council Appointed Commissions:

The commission appointed by council option differs in a dramatic way from the commission selected from council. It *occasions a significant division of responsibility between the council and the commission*. This is an important distinction in that the commission is thereby removed from council politics, in most all its manifestations, although the two are integrated through the *ex officio*

representation of the mayor on the commission. The option also permits the water utility to operate with *freedom from the decision-making overload and policy paralysis that can occur with the council being the only approving agent for municipal issues*. In the result, the utility has the business autonomy that is intended by the commission structure, permitting it to operate an unencumbered customer-driven business.

One principal advantage of the commission having business autonomy is that it *permits flexibility in administrative practice*. The most obvious case is in budgeting and accounting. The commission can operate with dedicated revenues for capital projects and renewal based on a user-pay system and full-cost accounting. The less obvious advantages are that the water utility, removed from the uniformity of municipal administration, can experiment with dynamic and creative administrative and operational practices. This permits *benchmarking on an industry standard basis*, which is the true test for a utility, rather than across the range of functions within the single municipality.

The rationale for this direction in water utility administration is that it *separates the municipal taxpayer and the utility ratepayer through a clear division of their interests*. While these are the same people and businesses, their use of municipal and utility services are not always the same. For example, utility ratepayers will have cause to resent the cross-subsidization of municipal services out of municipal revenues, just as municipal taxpayers will resent utility infrastructure being paid through property taxes.

### 3.3.3 Weaknesses – Council Appointed Commissions:

The character of the weaknesses of the commission appointed by council model depends on one's perspective on the degree of utility autonomy that results. While it might seem an impossibility, the perceptions of the weaknesses can range, on the one hand, from the belief that the water utility has too much autonomy from the municipality and, on the other, that it lacks any autonomy from the municipality. In general, the issues surrounding the first scenario, autonomy from the municipality, (which have been discussed above in the context of the advantages of utilities operated as departments), hold here (and do not need to be repeated). The issues surrounding the lack of autonomy from the municipality, for their part, need to be seen in comparison with the elected alternative to an appointed commission, which is discussed in the next section.

Although appointed commissioners do not bring council politics to the commission (like the case of commissioners appointed from council), they nonetheless have conflicting loyalties. This results from the business obligation of the commissioners being the needs of the customers, but their appointment and re-appointment depending on the political patronage of the municipal council. This governance option for water utilities is *most effective when commissioners are chosen for their stature in the community or business as opposed to their connections to municipal councillors*.

If the water utility operates as an autonomous business, however, there are potential weaknesses resulting from the lack of integration and coordination of utility operations with those of the municipality. For starters, *there are no efficiencies of scope and scale to be reaped from the formal*

*integration of the utility into the administration of the municipality.* The advantages of budgeting and accounting, including cross-subsidization, are also missed, although it is generally recognized that the last does not provided for sound utility administration whether the utility is a department or a commission. Overall, however, *utility autonomy may be an impediment to unified and uniform policy positions or prescriptions within the municipality.*

### 3.3.4 Observations -- Council Appointed Commissions:

The autonomy of commissions from councils is only a problem for adherents of a management philosophy based on a command and control hierarchical model. It is now increasingly recognized in business and government that *competition and benchmarking is a much more effective model for efficiency improvements.* In such a path, organizations that in the command model would be perceived to be in conflict can simply negotiate, barter and cooperate in their overlapping objectives. The real efficiencies in administration can be driven through subcontracting agreements between the municipality and a commission, with single bill collection being such an example.

## 3.4 Commission Chosen by Municipal Electors

### 3.4.1 Background:

While the elected commission concept is now facing intense scrutiny through municipal restructuring, it is an *enduring and resilient form of water utility governance that has stood the test of time.* The *Municipal Waterworks Act, 1882* structure of the elected commission, including the provision for *ex officio* representation for the mayor or head of council, has continued since that time basically unchanged through the *Public Utilities Act, 1913.* Many of the points raised above in the commission appointed by council option are applicable to the commission elected by the public model, but the differences result from the elected basis for the commission.

Where the early statute allowed for either councils or commissions (or private companies) to operate public utilities, commissions were generally the (public sector) preference in two cases. The first was where municipal government itself was not well developed. This route *followed in the Ontario tradition of creating local boards for well defined functions.* Water commissions, for example, were established for fire protection and public health reasons when, besides possibly schools and roads (which would have had boards as well), these might have been the only significant functions performed in a municipality. With the original *Municipal Act* having been passed only in 1849, other municipal structures were not well developed in the late 19<sup>th</sup> century outside the major centres.

The second case for creating commissions stems from the rapid movement to industrialization and urbanization in Ontario at the turn of the 20<sup>th</sup> century. With these changes new reasons developed for establishing elected commissions. Municipal governments, displacing provincial control, had in many places just become important in local affairs. The wielding of this new local power and influence often resulted in the complaint that municipal politicians were either inept or corrupt. On some policy issues,

increased provincial oversight was the outcome. For water utility matters, which *needed financial stability and removal from the vagaries of short-term political considerations*, the commission form of utility governance became attractive, especially in the eyes of business users and the provincial government.

In this environment, the *Public Utilities Act* was passed in 1913 to give greater direction to the public utility sector. This changed utility governance in a significant way. The Act permitted the establishment of multi-function public utilities commission (PUCs), enabling for example an existing water commission to add other functions like electricity. *This option provides the best balance of political control and business autonomy, but the control is exercised by electors rather than the council.*

### 3.4.2 Strengths -- Elected Commissions:

The primary advantages of the commission chosen by electors form of water utility governance is that the *commissioners have no competing objectives, public or private. Their only objective is to ensure the long-term supply of water at cost.* This enables the utility commissioners to operate the utility as a business, as in the case of appointed commissions, but also *without any divided loyalties* resulting from council appointment. The justification for doing so stems from the utilities being financed through rates rather than taxes, which makes them unlike other municipal services. Although they are ultimately owned in law by the municipality, their rate financing base makes their operation, in effect, customer cooperatives.

*Elected commissions permit the utility operations in an municipality to have their distinct identity and maximize it for the benefit of the customer.* While there may also be benefits to the municipality through integrating utilities in the municipal administration, the orientation of the utilities would then be to the needs of the municipality, and only indirectly to the needs of the customer. Dividing responsibility for utilities from other municipal services makes sense because of the customer focus and the self-contained nature of the operation.

While ensuring that the commissions are accountable to customers may seem an insufficient reason for water utility commissions to be directly elected, there is a more philosophical economic argument underpinning the position. Where utilities operate infrastructure monopolies such as water systems, customers do not have "exit" to other suppliers. There are no market forces that can be brought to bear on the monopolist. However, with a public utility the *customers can have "voice" through open business meetings and regular elections.* Elected commissions provide a connection for customer voice to those operating the utilities. In return, the *commissioners have only one focus, the utility operation, whereas municipal councillors have many other concerns.*

Like the case of council appointed commissions, elected commissions can serve the customer interest by using the *flexibility in administrative and operation practices* that is permitted. The orientation is also to the utility industry and its industry standard practices rather than to the municipality and the practices in government. Although this can lead to conflict with the municipality, the *dynamic*

*environment actually can generate creativity in administrative and operational practices that permit benchmarking between the commission and the municipality, to the benefit of both.* Conflict and tension are not always negative attributes. The alternative is one bureaucratic hierarchy.

### 3.4.3 Weaknesses -- Elected Commissions:

The weakness of elected commissions, as distinct from appointed commissions, results from the *potential for conflict between the commission and the council, with the council not even having the power to remove the commissioners because of their direct election.* This requires the council to enter negotiations with the commission to resolve differences as legal equals. Councils can exercise control over commissions that wish the municipality to sponsor debt, but this should be considered an obligation rather than a discretionary power for the justified debt of a legally constituted commission. Many water utilities do not have extensive debt requirements because they either finance expansion and renewal out of revenues or development charges, and thus can operate with freedom from the council's role in the utility's affairs.

This freedom illustrates the essential problem for councils of utility autonomy in municipal governance. The *council would prefer to be the single voice of the municipality*, whether it be to the provincial government, businesses wishing to locate in its community or local residents. But the reason is more than a claimed inability to speak about the local scene because the mayor, being an *ex officio* member of the utility commission, would be aware of water matters. The problem is rather that the council, as noted in the options above, is *precluded from using utility rates to provide cross-subsidies and bonusing, and is powerless to force the commission to do so.* The same is true of the council's objectives of reducing municipal costs overall by merging water utility operations with municipal functions for economies of scope and scale.

### 3.4.4 Observations -- Elected Commissions:

The problems elected commissions are thought to create are often exaggerated, stemming more from the inability of the council simply to impose its will. Ontario, for the most part, has been well served by the autonomy by which elected commissions have provided water utility services in municipalities, precisely by *removing municipal council political considerations from the utility decision-making calculus.* The recent experiments in council control over utility commissions have not been in place sufficiently to long to make general assessments, but the experience is not good to date.

Municipalities that have good relations with their elected commissions should move cautiously in any evaluation of the future of their elected commissions. *Large bureaucratic entities, such as municipalities with direct control over all utility services, are not a sound basis for efficient business enterprises.* It is ironic that Ontario should be moving in this direction just as it is becoming well established that competition is a greater driver of efficiency than hierarchy. This will be increasingly the case as utilities move into the competitive environment ahead, where customer service will be the primary basis for customer loyalty.

### 3.5 Franchise Awarded by Council

#### 3.5.1 Background:

The franchising of water utilities has long been available to municipalities in Ontario, but it is an *option that has not be utilized to any great extent*. This may change as a result of the enactment of the proposed redraft of the *Municipal Act* to the permissive 'natural persons' governance framework. Under this new framework, a municipality would be able either to *use bylaws to keep or create public utilities or use franchise contracts for alternative service delivery*. The process for changing providers has been greatly expedited now that referendums are no longer required to establish or disestablish a commission or franchise under the *Public Utilities Act* and the *Municipal Franchises Act*.

What has not been clear in the public discussion of the advantages and disadvantages of alternative service delivery operations is that there is no mechanism in Ontario law for the outright sale in perpetuity of utility operations. Statutory authority would be required to remove current municipal control over the utility operations and place them under environment ministry legislation, possibly to create area water distribution companies unrelated to municipal boundaries. *Franchises, nonetheless, leave the franchisee with extensive business autonomy and the least amount of political control.*

#### 3.5.2 Strengths -- Franchises:

There are two primary advantages of franchising water utility operations to alternative service delivery providers, whether they be private companies like Consumers Utilities or other public entities such as the Ontario Clean Water Agency. The municipality has the *administrative flexibility to avoid the operational burden of running the utility and has the financial incentive for doing so through the franchise fee it can receive from the franchisee*. On the latter, the municipality, if it owns the assets of the utility, can either sell or lease the assets to the alternative service delivery operator, with the price possibly being determined in excess of book value for the assets.

Franchising may prove attractive in both small and large municipalities. In small municipalities, franchising removes the need for the municipality to establish a large water utility operation and work force, possibly larger than that required for the municipality itself. Moreover, in serving the needs of small municipalities, a public utility may not have the customer base to reach the economies of scale achievable in the utility operation. This will be apparent in the benchmarking of costs among municipalities on an industry standard basis for the utilities. *A franchise utility operator, on the other hand, can establish these economies over a number of municipalities, and ones which do not have to be contiguous*. The municipality, if it is searching for all efficiencies for its residents and utility customers, will need to take this benchmarking factor into consideration. If it does not, its costs may be in excess of other municipalities, which will not give it good location advantages in keeping and attracting residents and businesses.

In large municipalities, franchising to alternative service delivery providers may also prove attractive precisely because of the large customer base. *While the municipality may be able to run the water*



*utility at low cost itself, it also has the market power to strike a favourable franchise deal.* Moreover, it will have the financial and legal resources to ensure a deal is favourable, something that may not be available to a small municipality.

From the customer perspective, a franchise water utility may prove advantageous over a public utility in the case where the alternative service delivery provider already owns the assets. Such a situation will occur when a municipality, through restructuring or another mechanism, ends up with territory served by a non-municipally owned public utility, such as OCWA or Philip Utilities. The advantage stems from the municipality not having to buy out the franchisee, with the debt obligations thereby not having to be repaid through rates. In the new municipal framework, just as in the past, *the municipality is not required to have uniform service delivery, and thus could keep a franchise relationship.* The alternative is to buy out the franchise.

### 3.5.3 Weaknesses -- Franchises:

The primary disadvantages for the municipality in franchising water utility operations stem from the potential loss of control over the utility. Control will always be a contentious issue because the franchise contract terms govern the municipality's relations with the franchisee. *Once the contract is awarded, the municipality cannot use its bylaw powers to regulate utility matters or change the contract unilaterally.* It will be restricted to the terms of the contract. This means that a franchising arrangement is only as good as its contractual language.

Reliance on individual municipalities to look after their own interests in franchising may prove problematic in Ontario. The reason is that the *Municipal Franchises Act* is extremely rudimentary, save possibly for the provisions regarding natural gas franchises, because of the *long and successful experience with public utility commissions.* Until now, *franchising has been considered a second best option* and, because the rules were never seriously tested in water, the ground is, for the most part, uncharted. York Region's negotiations with Consumers Utilities, which emphasized full disclosure and a rigorous tendering process, may have gone along way to establishing a framework for franchising, although the region did not actually follow through with granting the franchise.

Loss of direct council or commission control also has the potential for political repercussions for municipalities. This stems from a not often considered factor. *Despite taxation costs, a private utility provider actually has a cost advantage over public utilities in that it can operate with bottom-line financial considerations upper-most.* Public water utilities have traditionally operated with top-of-line considerations because of the greater demands of public accountability for the council or the commission. The result is that the franchising of water utility operations, while financially attractive, may not relieve the municipality of politically accountable for the utility's operation.

Public accountability is a serious issue in water utility operations because of the monopoly nature of the business. The only exception is the non-infrastructure components that can be or may become subjected to competition. If a franchisee operates like a traditional private monopolist, unreceptive to customer complaints and reaping monopoly rents, *the customers may have no option but to complain*

*to the municipality – the body that awarded the franchise.* If the municipality is constrained in its ability to respond to customer complaints by the terms of the franchise agreement, there may be consequences for elected officials at the next municipal election.

Other problems with franchises stem from the process of awarding and re-awarding the contracts. The lack of experience with franchising in Ontario, especially in water, and the value of the franchises to the alternative service delivery providers, means that *there is potential for public mistrust of the process of selection.* In private business it would be customary for the contractor to win over the business, but for municipal water utility operations the council would need to be careful to avoid the temptation of being persuaded to award the contract on other than a purely business-case basis.

A related problem is that the franchisee has an incentive to out-bid competitors for the operation of the water franchise, knowing that the cost can be charged back to customers through rates. This will be especially a problem in a situation where there is not some form of performance-based regulation or benchmarks, municipality to municipality. Although the British privatization of water systems differed in that they were outright sales unconnected to municipal franchises, the impact on the customer would be the same in a non-regulated environment. The customers, having paid for the infrastructure through rates, would *pay for it a again in post-privatization rates in order to relieve the debt of the new owners.*

The problem of re-awarding the contract is also serious for the performance of the water utility. The franchisee has an incentive to reduce the level of capital improvements as the franchise agreement nears completion. The reason is that, in the event that the franchise is not held, the utility can maximize earnings. Moreover, running down the infrastructure gives the franchisee an advantage in renegotiation in that the utility is not worth as much as it otherwise would have been in good repair. *All of which goes to show that franchising does not remove politics from utility matters.* Indeed, franchising can result in problems for the municipality in terms of planning if the utility requirements are not available for local development.

It is for these reason that the business community is often divided over the merits of privately-owned utilities. Manufacturing interests have tended to favour public utilities over the private utilities because of the greater degree of public accountability and because the top-of-line service is essential to their business operations. When utilities are not performing as expected, business can suffer. *In the near future Ontario can expect customers, and especially business, to make performance demands on utilities and be compensated for loss in the event of poor performance by the utilities.* And in this regard, public utilities may no longer have an advantage. Competition is driving all utilities to provide such reliability guarantees, and the private sector is currently ahead of the public because of its greater business flexibility.

#### **3.5.4 Observations -- Franchises:**

A great deal of work needs to be undertaken to establish the general rules for franchising utilities by municipalities, but the public will to do so does not appear to exist. Rules may serve to stand in the

way of the deals that municipalities can strike. Moreover, the rules would need to be prescriptive and brought in by the province, which goes against the permissive framework that the province is putting in place for municipal governance.

**Notes:**