Ministry of Finance

Electricity Sector—Stranded Debt

Background

We provided updates in past Annual Reports on the electricity sector's stranded debt, defined as that portion of the total debt of the old Ontario Hydro that could not be serviced in a competitive market environment when the electricity sector was restructured 12 years ago. We provide another such update this year, along with information on the Debt Retirement Charge (DRC), a component of nearly every Ontario ratepayer's electricity bill.

Detailed Review Observations

HOW DID THE STRANDED DEBT ARISE?

With passage of the *Energy Competition Act, 1998* (which included the *Ontario Energy Board Act, 1998* and the *Electricity Act, 1998*), the Ontario government launched a major restructuring of the province's electricity industry.

The two most significant aspects of this restructuring were the creation of competitive wholesale and retail markets for electricity that opened May 1, 2002, and the breakup of Ontario Hydro into five successor companies on April 1, 1999. The new entities and their functions were:

- Ontario Power Generation (OPG) for electricity generation;
- Hydro One for wholesale power transmission and retail distribution;
- the Electrical Safety Authority for electrical inspection;
- the Independent Electricity Market Operator to manage the power grid and the wholesale electricity market; and
- the Ontario Electricity Financial Corporation (OEFC) to manage the legacy debt and other liabilities not transferred from the old Ontario Hydro to successor companies.

The intent of restructuring was to have the new entities operate in a commercial manner, with a strong financial footing that would make them more efficient and effective and lead to prices that were as low as possible for consumers.

Under the old monopolistic rate-regulated system, Ontario Hydro tried to set electricity prices at a level that ensured all costs, including principal and interest payments on debt, were eventually recovered from customers. With the introduction of competition, however, Ontario Hydro's commercial successor companies no longer have the assurance that they can recover all costs, especially those incurred in previous years and still outstanding, through free-market electricity rates.

One of the most critical steps in the restructuring process was to determine the fair market value of the Ontario Hydro assets transferred to the new entities. Both Ontario Hydro and the government, assisted by private-sector investment firms and other experts, recognized that the market value of these assets in a competitive environment would be significantly less than the amounts recorded in Ontario Hydro's books. It was anticipated that in a competitive market, revenues and profits generated by the successor companies would not be sufficient either to justify the existing recorded asset values or to service Ontario Hydro's substantial outstanding debt.

On April 1, 1999, the Ministry of Finance determined that Ontario Hydro's total debt and other liabilities stood at $38.1 billion, which greatly exceeded the estimated $17.2-billion market value of the assets being transferred to the new entities. The resulting shortfall of $20.9 billion was determined to be "stranded debt," representing the total debt and other liabilities of Ontario Hydro that could not be serviced in a competitive environment.

Responsibility for servicing and managing the legacy debt of Ontario Hydro, which includes the stranded debt, was given to the OEFC, whose opening balance sheet reflected a stranded debt or unfunded liability of $19.4 billion. This amount represented the difference between the $18.7-billion value of assets assumed by the OEFC and the $38.1 billion of Ontario Hydro legacy debt and other liabilities that the OEFC also took on. It should be noted that the stranded-debt figure of $19.4 billion listed as an unfunded liability in the OEFC's April 1, 1999, financial statements does not agree exactly with the total of $20.9 billion in Figure 1 because of certain accounting adjustments, consisting mainly of $1.2 billion in deferred debt costs.

Because the OEFC had neither the assets nor the expected revenue streams from the value of the other Ontario Hydro successor companies to fully service the debt obligations it had assumed, the

Figure 1: Financial Impact of the Restructuring of the Electricity Sector ($ billion)

Source of data: Ministry of Finance

Former Ontario Hydro debt and liabilities	38.1
less	
Value of new generation and service companies	17.2
equals	
Stranded debt	20.9
less	
Expected dedicated revenue streams	13.1
equals	
Residual stranded debt	7.8

Electricity Act provided for other revenue streams, and the government developed a long-term plan to provide the OEFC with revenue streams to service the existing debt and ultimately retire the stranded debt. A key government policy decision at the time was that all electricity-sector debt would be repaid by the electricity sector and ratepayers rather than from general tax revenues.

To service and retire the $20.9 billion in stranded debt, the government established a long-term plan wherein the burden of debt repayment would be borne partly through dedicated revenues from the electricity-sector companies—OPG, Hydro One, and Municipal Electrical Utilities (MEUs)—and partly by electricity consumers. This would be broken down for the electricity sector as follows:

- The electricity companies would make payments in lieu of taxes (PILs) to the OEFC. PILs are equivalent to the corporate income, property, and capital taxes paid by private corporations. Before April 1, 1999, these companies were not required to make any of these payments.
- The cumulative annual combined profits of OPG and Hydro One in excess of the government's $520-million annual interest cost of its investments in the two companies would go toward repaying stranded debt.

As of April 1, 1999, the present value of these two dedicated revenue streams was estimated at

$13.1 billion. The estimated balance remaining on the $20.9-billion stranded debt, amounting to $7.8 billion, was called the "residual stranded debt," and the *Electricity Act* provided for a new Debt Retirement Charge (DRC) to be paid by electricity consumers until the residual stranded debt was retired. In essence, this was the estimated portion of the stranded debt that could not be serviced by the estimated present value of the two dedicated revenue streams from the electricity companies.

This structure was intended to achieve the elimination of the stranded debt in a prudent manner, and to distribute the burden of debt repayment between electricity consumers and the electricity sector (OPG, Hydro One, and MEUs).

Figure 1 illustrates the significant determinations made at the time of restructuring.

Figure 2: Progress in Repayment of the Stranded Debt, 1999/2000–2010/11 ($ billion)

Source of data: OEFC

Fiscal Year End	
at April 1, 1999	19.4
1999/2000	20.0
2000/01	20.0
2001/02	20.1
2002/03	20.2
2003/04	20.6
2004/05	20.4
2005/06	19.3
2006/07	18.3
2007/08	17.2
2008/09	16.2
2009/10	14.8
2010/11	13.4

PROGRESS IN RETIRING THE STRANDED DEBT

Figure 2 illustrates the progress made in reducing the total stranded debt as reflected in the OEFC's audited financial statements. It should be noted that the OEFC's financial statements currently report only the total outstanding stranded debt and not the residual stranded debt, which is a component of total stranded debt. This is consistent with the *Electricity Act, 1998,* which requires that the outstanding amount of the residual stranded debt need only be determined and disclosed "from time to time," as discussed later in this section.

Progress in retiring the overall stranded debt over this period has been slower than anticipated, due primarily to the lower-than-expected profitability of Hydro One and, particularly, OPG. The lower their respective earnings, the lower the PILs they make to the OEFC, and the less they contribute to the electricity-sector dedicated income payments. The uncertainty inherent in forecasting the financial performance of the electricity sector becomes apparent on examination of the actual revenues produced by this sector. As reported in the OEFC's audited financial statements, PILs revenues have varied from a low of $321 million in the 2010/11 fiscal year to a high of $949 million in 2005/06, while electricity-sector dedicated income has ranged from $0 in 2001/02, 2003/04, and 2008/09 to a high of $771 million in 2010/11.

As we reported in last year's Annual Report, some of the factors that have affected OPG's profitability over the past 11 years include the following:

- Electricity-generation projects such as the Niagara tunnel project have had cost overruns, with costs being almost double their original estimates and completion dates running years behind schedule.
- Investment returns on the $11-billion nuclear removal and waste management funds, reflected in OPG's financial statements, have been volatile. Canadian accounting standards require OPG to reflect unrealized gains and losses in its net income.
- There has been public and political pressure to keep electricity rates low, which impacts the profitability of the sector.

As well, OPG's future profitability and, consequently, the pace of the reduction of the recorded stranded-debt balance may be impacted by uncertainty about which costs the Ontario Energy Board (OEB), which regulates rates, will allow OPG to pass on to its customers. In a recent application, for example, OPG sought a 6.2% rate increase for power produced by its major generating stations. However, the OEB granted just 1%. At the time of this writing, OPG was appealing parts of the OEB decision, but should it lose the appeal and be unable to reduce costs, OPG will experience lower profitability.

THE RESIDUAL STRANDED DEBT AND THE DEBT RETIREMENT CHARGE (DRC)

In recent months, issues surrounding the electricity Debt Retirement Charge (DRC) have been raised both in the Legislature and in the media. These issued have included questions such as:

- Are there any restrictions on what the DRC can be used for?
- How is the residual stranded debt determined?
- How long will the DRC remain on electricity bills?

Accordingly, we decided to incorporate a review of the DRC in this year's update. Because charges of this nature typically need to have underlying legislation or regulations that authorize their collection, a key aspect of our work was a review of the underlying legislation with respect to the levying and use of the DRC. We also wanted to provide the Legislature and the public with information that could help answer the above questions.

What Can the DRC Be Used For?

Collection of the DRC began on May 1, 2002, the day the electricity market opened to competition. The rate was established at 0.7¢ per kilowatt hour (kWh) of electricity and remains the same today. Currently, the OEFC collects more than $900 million a year in DRC revenue, and, as of March 31, 2011, approximately $8.7 billion in DRC revenue had been collected.

In announcing the DRC in 2000, the then Minister of Energy said that the objective of it was to pay down the estimated $7.8-billion residual stranded debt: "All revenues from the DRC will go directly to the Ontario Electricity Financial Corporation to be used exclusively to service the residual stranded debt. Once the residual stranded debt has been retired, the DRC will end."

Although this reference implies that the DRC must be used only to pay down the residual stranded debt, it is the underlying legislation that dictates the collection and usage of the DRC and that drives the actions of both the OEFC and the responsible Minister with regard to compliance.

Section 85 of the *Electricity Act, 1998* (Act), which is titled "The Residual Stranded Debt and the Debt Retirement Charge," gives the government the authority to implement the DRC, and this same section specifies when it is to end. The OEFC's 2010 Annual Report states that the Act "provides for the DRC to be paid by consumers until the residual stranded debt is retired. The debt repayment plan estimates residual stranded debt will likely be retired between 2015 and 2018"; and its 2011 Annual Report states that the OEFC "receives the Debt Retirement Charge paid by electricity consumers at a rate of 0.7 cents/kWh until the residual stranded debt is retired." Given that the wording in section 85 was, in our view, open to interpretation in several areas, we engaged external legal counsel to assist us. The following comments and observations take into consideration the opinion of our external legal advisers with respect to the interpretation of this section.

Although DRC funds collected are separately disclosed in the OEFC's financial statements, they are not segregated or separately accounted for with respect to the residual stranded debt, but are combined with the OEFC's other revenue sources and used for general corporate purposes. Our view, which is supported by legal advice, is that section 85 does allow DRC funds to be used for any purpose that is in accordance with the objectives and purposes of the OEFC. In essence, and notwithstanding the comments made by the then Minister when tabling the original legislation, section 85 does not restrict the application of the DRC to being used only to service the outstanding residual stranded debt. This means that the OEFC, in comingling the DRC funds collected with its other sources of revenue and in using all funds collected to carry out its legislated objects, has complied with the underlying legislation with respect to the DRC.

However, as discussed later in this section, we believe that the Minister does have certain additional responsibilities under section 85 with respect to when the collection of the DRC will end.

How Is the Outstanding Residual Stranded Debt Determined?

The Act does not specify precisely how the determination or calculation of the outstanding amount of the residual stranded debt is to be done, only that it be done "from time to time." However, the Act states that the government, by regulation, may establish what is to be included in the calculation of the residual stranded debt. As yet, though, no such regulation has been made. With respect to how to calculate the outstanding residual stranded debt at any one time, we believe that there are several possible approaches, including the following:

- Have the initial $7.8-billion residual stranded debt less the DRC collected to date equal the remaining residual stranded debt.
- Treat the initial $7.8-billion debt like a mortgage or loan, in which each DRC payment would go to paying interest and paying down the principal.
- Apply DRC revenues to the payment of a portion of the OEFC's operating expenses, in addition to interest and financing costs, because there are administrative costs associated with running the OEFC.
- Consider the residual stranded debt to be retired only when the OEFC's assets, which include the present value of projected revenue streams from the electricity sector, equal its liabilities.

The last approach was essentially the method used in the original 1999 calculation of the estimated stranded debt and residual stranded debt. We understand that it has continued to be used by the OEFC since that time. In effect, under this methodology, low past profitability or estimated future profitability in the electricity sector would result in more of the stranded debt being paid by electricity consumers through DRC payments, whereas high past profitability or estimated future profitability would reduce the amount of DRC payments needed from consumers.

Although the definition of residual stranded debt in section 85 does not include interest or other OEFC expenses, and notwithstanding the lack of specific statutory guidance as to how the residual stranded debt is to be calculated, we believe that the legislation does provide the Minister with a fair degree of latitude in determining how the residual stranded debt is to be calculated and reported. The legislation also allows, but does not require, the government to make regulations governing determinations of the stranded debt and the residual stranded debt for the purposes of section 85.

When Does Collection of the DRC End?

Section 85 requires that the Minister of Finance determine the total stranded debt, determine "from time to time" the residual stranded debt, and make these determinations public. When the Minister determines that the residual stranded debt has been retired, collection of the DRC must cease. Since passage of the Act over a decade ago, the Minister has made no such public determination of the outstanding amount of the residual stranded debt, and the DRC has continued to be collected.

From our perspective, the key question is what "from time to time" means. Can it be totally open-ended and left solely up to the discretion of the government of the day as to when such a determination will be made and the DRC collected indefinitely until that time? Or, if not, what would be a reasonable time frame within which the Minister should make a determination of the outstanding amount of the residual stranded debt to meet the requirements of section 85?

Our view is that it is certainly reasonable for the Minister not to have made a determination of the outstanding amount of the residual stranded debt obligation in the initial years after collection of the DRC began. However, we believe that the intent of section 85 is that the Minister must provide a periodic update to the consumers paying the DRC with respect to the status of this particular charge on their electricity bills.

Given that the DRC has been collected from electricity consumers for almost a decade and that more than $8 billion in DRC revenue has been collected during that time, our view is that the Minister should make a formal determination of the outstanding amount of the residual stranded debt in the near future and make this determination public. Consideration should also be given to that part of section 85 that allows the government to establish and clarify, by regulation, when such a determination will be made and how the amount of the outstanding residual stranded debt is to be calculated.

MINISTRY OF FINANCE RESPONSE

The Ministry of Finance (Ministry) concurs with the Auditor's report with respect to the Ontario Electricity Financial Corporation (OEFC) being in compliance with the *Electricity Act, 1998* (Act) in the use of Debt Retirement Charge (DRC) revenues. DRC revenues are used by the OEFC to perform its objectives under the Act, including servicing and retiring its debt and other liabilities. The OEFC's expenses included interest payments of about $1.6 billion in the 2010/11 fiscal year. Since March 31, 2004, the OEFC has had seven consecutive years of paying down its unfunded liability (often called the stranded debt), for a paydown from $20.55 billion as at March 31, 2004, to $13.448 billion as at March 31, 2011—a reduction of about $7.1 billion. Also, as provided for under the Act, the Ministry will be moving forward with proposed regulations under the Act on the determination of stranded debt and residual stranded debt.

The determination of residual stranded debt from time to time is subject to estimation and forecast uncertainty because a residual stranded debt calculation includes forecasting what future dedicated revenues to the OEFC will be. Such revenues depend on the financial performance of OPG and Hydro One, as well as other factors such as assumptions about future tax and interest rates.

This uncertainty has been reflected in the OEFC's 2011 annual report, which includes, as in previous years, an estimate of when the DRC is likely to end: sometime between 2015 and 2018.