Ministry of Finance

Electricity Sector—Stranded Debt

Follow-up to VFM Section 3.04, *2011 Annual Report*

Background

In past Annual Reports, we examined the status of 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 after restructuring of the electricity sector in 1999. We provided the last such update in our *2012 Annual Report*, along with information about the Debt Retirement Charge (DRC), a component of nearly every Ontario ratepayer's electricity bill.

The stranded debt came into being under the *Energy Competition Act, 1998*, which provided the legislative framework for a major restructuring of the electricity industry. This included the restructuring of the old Ontario Hydro into four main successor companies: Hydro One, Ontario Power Generation (OPG), the Independent Electricity System Operator (IESO) and the Ontario Electricity Financial Corporation (OEFC). OEFC was given the responsibility to manage the legacy debt of the old Ontario Hydro, along with certain other liabilities not transferred to Hydro One and OPG under the restructuring.

OEFC inherited $38.1 billion in total debt and other liabilities from Ontario Hydro when the electricity sector was restructured on April 1, 1999. Less than half of the $38.1 billion was supported by the value of the assets of Hydro One, OPG and the IESO. The remaining $20.9 billion not supported by the value of these assets was the initial stranded debt.

The government put in place a long-term plan to service and retire the $20.9-billion stranded debt, which included dedicating revenue streams to OEFC to help pay down this debt:

- At the time of the restructuring, the estimated present value of future payments in lieu of taxes from the electricity-sector companies (OPG, Hydro One and the municipal electrical utilities), and of future cumulative annual combined profits of OPG and Hydro One in excess of $520 million a year (the annual interest cost of the government's investment in the two companies) was estimated at $13.1 billion.
- The remaining $7.8 billion, called the residual stranded debt, was the estimated portion of the stranded debt that could not be supported by the expected dedicated revenue streams from the electricity companies. The *Electricity Act, 1998* (Act) authorized a new Debt Retirement Charge (DRC), which electricity ratepayers would pay until the residual stranded debt was retired.

The plan was intended to eliminate the stranded debt in a prudent manner while sharing the debt-repayment burden between electricity consumers and the electricity sector.

Collection of the DRC began on May 1, 2002, at a rate of 0.7 cents per kilowatt hour (kWh) of electricity, a level at which it remains today. Currently, the OEFC collects between $940 million and $950 million a year in DRC revenue, and had collected a total of about $10.6 billion as of March 31, 2013.

Our *2011 Annual Report* focused on providing details about:

- how much DRC revenue the government had collected;
- the progress in eliminating the residual stranded debt; and
- when electricity ratepayers might expect to see the DRC fully eliminated.

Section 85 of the Act, entitled "The Residual Stranded Debt and the Debt Retirement Charge," gave the government the authority to implement the DRC, and this same section specifies when it is to end. The key observations from our *2011 Annual Report* were based on our interpretations of the provisions of section 85, and on our assessment of whether these provisions had been complied with in both spirit and form. Specifically, section 85 requires that the Minister of Finance determine the residual stranded debt "from time to time," and make these determinations public. When the Minister determines that the residual stranded debt has been retired, collection of the DRC must cease.

While the Act did not specify precisely how the determination of the residual stranded debt was to be done, it does allow the government, by regulation, to establish what is to be included in its calculation. We also observed that the term "from time to time" was not formally defined, and could be left solely up to the government of the day to determine. Our *2011 Annual Report* noted the Minister had made no such public determination of the outstanding amount of the residual stranded debt since April 1, 1999. Our view was that section 85 conferred on ministers an obligation to provide a periodic update to ratepayers on the progress their payments were making to pay down the residual stranded debt. We concluded that a decade was long enough, and suggested the Minister should provide ratepayers with an update.

Status of Actions Taken on Recommendations

In response to these observations, the government introduced Regulation 89/12 under the Act on May 15, 2012, to provide transparency and meet reporting requirements on the outstanding amount of residual stranded debt. The new regulation formally establishes how the residual stranded debt is to be calculated, and requires annual reporting of the amount in *The Ontario Gazette*.

We were pleased to see this increased level of transparency was also reflected in the 2012 Ontario Economic Outlook and Fiscal Review and in the 2013 Ontario Budget; both indicated the Minister of Finance determined the residual stranded debt to be $4.5 billion as at March 31, 2012, consistent with the estimate provided in the 2012 Budget. The 2013 Ontario Budget also contained a chart, reproduced here as Figure 1, reflecting annual residual stranded debt estimates back to April 1, 1999, and amounts going up to March 31, 2012. Under Ontario Regulation 89/12, the determination of residual stranded debt as at March 31, 2013, will be made by the Minister of Finance after the OEFC submits to the Minister its annual report, including the audited financial statements, and by no later than March 31, 2014.

Figure 1: Residual Stranded Debt and OEFC Unfunded Liability for Each Fiscal Year Since 1999 ($ billion)

Source of data: 2013 Ontario Budget