Stranded Debt Ten Years Later
(part of “Ontario Power Rate Rip-Off” series)

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When Ontario Hydro was dissolved in 1999, one of the major public concerns was its legacy of liabilities. Ontario Hydro's accumulated liabilities were primarily in the form of bonds, nuclear waste liabilities and costly power purchase agreements. Offsetting those liabilities were assets, primarily power stations, wires and the resale of purchased power. The then Conservative government promised it had a plan that would see the legacy of excess debt retired within 10 years.

With the passage of ten years, how is the debt reduction program working?

Successive government's assurances about debt reduction have proven to be unfounded. The proceeds of the special electricity tax initially intended for eliminating Ontario Hydro's liabilities -- called the Debt Reduction Charge (DRC) on your power bill -- has been misappropriated to fund new spending.

Ontario Electricity Financial Corporation (OEFC) was initially created with $38.1 billion in total debt and other liabilities from the former Ontario Hydro when the electricity sector was restructured on April 1, 1999. This amount included $30.5 billion in total debt. A portion of the $38.1 billion was supported by the value of the assets of Ontario Hydro's successor companies. The official view was that there was $20.9 billion of "stranded debt" -- debt that was not supported by assets. This $20.9 billion was comprised of an initial unfunded liability of $19.4 billion adjusted for $1.5 billion of additional assets. Of the stranded debt, a subcategory of "residual stranded debt" was identified by the government. The only time residual stranded debt was defined and given an estimated value was when it was established. That amount was $7.8 billion. The government's assurance was that the Debt Reduction Charge (DRC) would pay down the residual stranded debt. All Ontario electricity consumers served by the former Ontario Hydro have been paying the Debt Reduction Charge (DRC) of $7/MWh since the market opened in 2002. The rest of the stranded debt (that is the portion not including "residual stranded debt") was to be serviced from dedicated revenue streams -- from payments in lieu (PILS) from LDCs and all net income generated by OPG and Hydro One that exceeded the cost of financing the Province's debt equity swap (i.e. $520 M per year).

The most recent annual report of OEFC, publicly released September 25, 2009, proves that cost growth has overwhelmed the original debt reduction plan.

OEFC's latest report maintains the original official justification for the DRC. "The Electricity Act, 1998, provided for the debt retirement charge to be paid by consumers until the residual stranded debt is retired. The debt repayment plan supports estimates that the residual stranded debt will likely be retired between 2014-2018".[1]

The officially estimated date for retiring the electricity debt has been skidding backwards since the end of Ontario Hydro. In 2001, OEFC was assuring the public that <u>all</u> the old Ontario Hydro debts would be cleaned up by 2010.

[1] Ontario Electricity Financial Corporation, Annual Report 2009 p. 5.

Whereas $6.85 billion[2] in DRC proceeds have been collected from consumers since market opening, OEFC reports that the initial unfunded liability has declined by only $3.2 billion. The portion of this progress that is attributable to reduction in actual debt, as opposed to nuclear waste and over-market non-utility generation (NUG) contracts, is just $2.9 billion. If the DRC had been actually dedicated to paying off the $7.8 billion in residual stranded debt, then this happy result would be expected to happen in 2013, assuming a discount rate of 7.5%, which was the average interest rate on the original Ontario Hydro debt.

Even this modest progress exaggerates the gains achieved as a result of DRC payments made by consumers. OEFC's progress in debt reduction is particular weak considering the 2005 decision of the McGuinty government to increased power rates, in part by allowing OEFC to flow through directly to consumers the full extent of its annual NUG costs. From the time of market opening until the end of 2004, the average losses to OEFC on the NUG contracts were about $220 million per year. The originally estimated negative net present value of the NUG contracts was $4.3 billion.

Effectively, of all the revenue streams originally expected to pay down the stranded debt, only the DRC revenue has been applied against the original “stranded debt” bequeathed by Ontario Hydro. Even new revenue streams, such as the NUG flow-through, appear to have had little effect on the balance owing.

Under the original debt reduction scheme, eliminating the residual stranded debt would have been significant because the residual stranded debt was the justification for the DRC. When the residual stranded debt disappeared, consumers were to be entitled to the welcome relief of no more DRC. The continuing flow of dedicated revenues, such as PILs, would still be available to pay off the rest of the stranded debt.

A key reason that stranded debt has moved only a little in the favourable direction over the last 10 years, and a key reason that the DRC may not disappear for a very long time into the future, is that the level of dedicated revenue stream is dependent in part on OPG's net income. OPG was expected to, and agreed to as a condition of its debt bailout when it was created in 1999, pay off its portion of the "stranded debt" while subject to the Market Power Mitigation Agreement (MPMA). The MPMA limited OPG's revenue to $38/MWh. Relative to the plan underpinning the MPMA, OPG has enjoyed several major revenue bailouts. In 2005, with OPG facing insolvency, the McGuinty government relieved the big generator of having to refund MPMA rebates to consumers. Effectively, OPG reneged on its half of the quid pro quo that was the basis for having almost all of its debt eliminated in 1999. Also in 2005, OPG's nuclear and some of its hydro-electric capacity also became regulated. The attendant regulatory mandate relaxes revenue controls on OPG further. In addition, OPG is now receiving special payments for reducing output from coal units. In 2009, OPG's average revenue was been $60.7/MWh. Notwithstanding a 60% revenue increase since the days of the MPMA, OPG's net income still lags. No matter what its revenues, OPG has found costs to match them and more.

By contrast, Hydro One has proven to be a reliable net income producer without exploding costs. Since 2003, Hydro One has earned in the range of $400 to $500 million every year. In the period 2003 until 2008, Hydro One's costs increased by only 10.5% delivering a fairly constant level of service over the period.

In OEFC's fiscal year 2008/09, OPG lost $83 million and Hydro One earned $518 million, leaving the Provincial government owing $85 million to OEFC on the year. OPG's loss was

[2] This figure is the undiscounted arithmetic sum of payments.

primarily driven by losses in the market value of its nuclear waste disposal and decommissioning reserve.

Hydro One's earnings plus about $850 M in PILs would see the OEFC paying down stranded debt, over and above what the DRC should be doing for residual stranded debt, by about $1.25 billion per year. Deducting the remaining residual stranded debt from the OEFC's unfunded liability and identifying this as the amount that has to be paid off with the dedicated revenues, with a discount rate of 7.5%, it would take about 25 years to pay the entire stranded debt off. Refinancing the original Ontario Hydro debt upon the maturities of the various issues at lower discount rates should be eliminating the debt even faster. However, the expected progress is not evident in OEFC's accounts.

In addition to OPG's weakness, another factor draining OEFC revenues is the government's repeated use of OEFC to fund policy initiatives. One example was the foolish policy of then Premier Ernie Eves to freeze residential rates announced November 11, 2002. Another was the 2005 rental generator program and debt repayment relief for OPG.

A new policy initiative imposed on OEFC is the requirement to fund OPG's coal phase-out program. Effective January 1, 2009, OEFC has been making "contingent support" payments to OPG to fund the government's coal reduction policy with the cost flowing though directly to rate payers through yet another addition to the Global Adjustment. In Q1 '09, the cost to rate payers was $39 million. According to OPG's quarterly statements, the cost to OEFC in Q2 rose to $141 million. In Q3, OPG discontinued reporting revenue from OEFC and as of May 11/'10 OPG has not yet produced its Annual Report for 2009.

Effectively, a substantial portion of OPG's net income is now derived from payments from OEFC although OEFC depends on OPG's performance for its debt retirement plan. Although the new coal reduction payments increase the flow of funds through OEFC, the policy does not increase OEFC's debt because the costs are matched by new Global Adjustment charges to customers.

Coal related payments to OPG are just one portion of the huge growth in Global Adjustment in recent times. McGuinty is using Global Adjustment to move the costs of government policy initiatives, and indeed direct Ministry of Energy operating costs, off the government's deficit on onto the power bills of consumers.

It is clear that the McGuinty government has abandoned the original purpose of DRC as being earmarked for paying down "residual stranded debt" into an instrument to fund other costs. As of 2007, the Ontario Power Authority was planning for consumers to pay between $1 billion and $800 million per year in DRC until the end of 2020.[3]

Transparency is sorely lacking. In every successive annual report issued by OEFC there are references to a debt reduction plan, its revisions, and the range of dates for paying down the stranded debt or the residual stranded debt. However, no iteration of that plan or its successors has ever been made public. Consumers have no idea how OEFC arrives at its estimated debt repayment date. Without the debt repayment plan and its updates being publicly available, there is no way to follow our money and to keep those government agencies responsible for related aspects of the power system financially accountable.

No private securities issuer would be allowed to get away with the black box debt repayment plan that OEFC strings us along with.

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[3] Ontario Power Authority, Integrated Power System Plan, Exhibit G2/T2/S1/p. 26.