The Fair Hydro Plan: "The Times They Are A Changing"… Again

07 mars 2017

The Ontario government's March 2, 2017 announcement of its "Fair Hydro Plan" marks a historic shift in direction in an electricity sector that has witnessed many transformational events over the past 25 years.

Historical milestones include:

- Premier Bob Rae's appointment of Maurice Strong to restructure the former Ontario Hydro – 1993;
- The Macdonald Committee Report in 1995 recommending a market-based alternative to the old Ontario Hydro;
- Carl Andognini's 1997 report on major deficiencies at Ontario's nuclear reactors;
- Market Design Committee and Bill 35 that restructured the electricity sector – 1998 to 2000;
- Electricity Market opening/closing and the imposition of a province-wide electricity rate freeze – 2000-2002;
- The coal phase-out announcement and the elimination of the rate freeze because "consumers must pay the real price for electricity" – 2003;
- The Green Energy Act – 2009; and
- The Fair Hydro Plan, March 2, 2017, severing the link between costs and rates.

The following offers preliminary observations on possible implications of this latest electricity policy development.

Ontario Energy Board: What will constitute "just and reasonable rates"?

Ontario's Fair Hydro Plan proposes to cut electricity bills of residential customers by 25%, in part by refinancing the Global Adjustment (GA). The Ministry of Energy (MOE) Backgrounder states that the government intends to introduce new legislation that will, among other things, outline the role for the Ontario Energy Board (OEB) in the GA refinancing.

By severing the link between rates and costs with the slack picked up by new debt instruments, the fundamentals of normal public utility regulation may no longer apply. In addition, shifting significant costs that directly relate to the provision of electricity services, from electricity customers to taxpayers, comingles the interests of ratepayers and taxpayers in ever more complex ways. These changes will likely raise a host of interesting questions concerning how the OEB discharges on a go forward basis, its various regulatory responsibilities involving distributors, transmitters, Ontario Power Generation and the Independent Electricity System Operator (IESO).

For example, could the OEB's legislated guiding principles be revised to expressly include a new mandatory criterion of only establishing "just and reasonable intergenerational rates?" Factual challenges in applying such a standard will be exacerbated if, as many believe, the electricity sector is on the doorstep of fundamental change through the emergence of new disruptive technologies such as lower distributed generation costs, self-sustaining micro grids and competitively priced storage options. In short, is the electricity sector today where the telecommunications industry was 25 years ago before profound technological changes completely, and permanently, altered how that industry operates? When the time comes to clear unpaid electricity accounts, will pressures caused by load declines accelerate?

Continuing this theme, suppose an OEB regulated entity advances and receives regulatory approvals for a capital program for assets expected to have a useful life of 40 years. But as a result of disruptive technology changes, it turns out that the useful life of those assets is really only 15 years. The result is the creation of stranded costs. Will intergenerational equity be served if future generations pay for stranded costs because the generation advancing and approving the expenditure "made the wrong bet" on technology? On the other hand given that the vast majority of utilities in Ontario are owned by either the province or municipal governments, ultimately taxpayers are the ones "on the hook" for stranded costs. Could the focus on intergenerational equity result in more short-lived investments being made by regulated entities as a means to mitigate such risk?

We note that part of the MOE's rationale for the Fair Hydro Plan is "decades of under-investment in the electricity system by governments of all stripes resulting in the need to make significant investments in generation, transmission and distribution assets." Beyond the reality that it is utilities – not government – that make these investments (and who have tried but failed in the recent past to achieve even greater system renewal investments, in some cases through the OEB process), will the sector-wide rate decrease provide a window of opportunity for utilities to accelerate and increase the quantum of infrastructure renewal applications? Since rate impacts associated with those investments appear to be mitigated through spreading costs amongst taxpayers as opposed to solely relying on ratepayers to recoup such expenditures, will the Fair Hydro Plan help facilitate greater and faster utility investment in infrastructure renewal?

Risk Management, Investment Climate

Senior management and their boards of directors identify areas of risk facing their various lines of businesses and implement strategies to manage such risk. Some may predict the Fair Hydro Plan to be a Black Swan event. Is it another reminder that Ontario's electricity sector can be subject to sudden, dramatic changes that can permeate through both regulated and competitive business lines? What the Fair Hydro

Plan ultimately means for the business plans of utilities, generators, energy marketers and others will need to be carefully considered, including potential new opportunities associated with the proposed Affordability Fund. Even if certain stakeholders, such as generators, may not be as immediately affected as others by the proposed Fair Hydro Plan, the overall and longer term policy and system implications are yet to unfold.

In a sector where stakeholders have often stressed the need for stability and predictability, the Fair Hydro Plan once again gives managers and directors reason to pause to consider the extent of control that they ultimately have on their businesses.

In 2003 former Energy Minister Dwight Duncan said, "The days of using energy as a political football are over. We are sending a clear signal that this government intends to deal with electricity issues in a practical, transparent and sensible way."(November 25, 2003)

Recent events illustrate how Ontario's electricity policy environment continues to be subject to pendulum swings.

LDC consolidation

One of the conclusions of the 2012 report of the Commission on the Reform of Ontario's Public Services, chaired by Don Drummond, was that consolidating the Ontario electricity distribution sector would result in approximately $1 billion in cost savings. Even if consolidation of the 60 or so remaining LDCs into 6 to 10 regional utilities could be achieved immediately, the entire $1B in projected cost savings would only fund about 5 months of the new GA refinancing costs under the Fair Hydro Plan.

While the rationale supporting continued LDC rationalization remains (beyond cost reduction) such as LDCs' need for new capital, mitigation of the risks of disruptive technology, etc., some municipal owners may decide to defer consolidation options since the rate relief promised with the proposed Fair Hydro Plan might provide a basis to postpone dialogue on this often controversial topic into the future (and after the next municipal election to be held in the fall of 2018).

Transparency: Understanding the Electricity Sector's New Global Revenue Requirement?

The government forecasts that the Fair Hydro Plan will initially reduce the GA by $2.5B per year for the first 10 years, with associated interest costs potentially as high as $1.4B annually. In addition, the government estimates a further $2.5B per year for the next 3 years in costs to implement the Fair Hydro Plan's electricity support and conservation programs, which are aimed at providing rate relief to residential consumers, small businesses and farms. We also know that other large costs will be added to the system in the next few years, including nuclear refurbishments at Bruce and Darlington. Further significant costs are also expected for on-going utility infrastructure renewal amongst other cost drivers.

The question arises whether the Fair Hydro Plan is sustainable over the long or even medium term given the range of additional significant new costs that will also require servicing.

Stakeholders would benefit if the Province (or one of its agencies) produced an annual consolidated balance sheet showing the total revenue requirement for the entire Ontario electricity sector. We note that the former Ontario Hydro prepared consolidated balance sheets that were made publically available. Having one consolidated balance sheet would allow the sector and general public to understand the actual financial impacts and track liabilities which would foster greater transparency, an issue that has been an on-going concern for some time.

IESO Market Renewal

The Fair Hydro Plan Backgrounder states that the IESO's Market Renewal initiatives are estimated to save at least $200 million per year starting in 2021. Consideration will need to be given to how IESO Market Renewal issues could be impacted as a result of the Fair Hydro Plan. For example, given the forecast of up to $25 billion plus interest in increased costs for GA financing, could a new IESO Market Renewal priority be the consideration of strategies to *increase* electrification demand in order to enhance electricity system revenues overall? In other words, reimagine Demand Side Management to foster strategies aimed at managing demand up?

The Fair Hydro Plan could also produce unintended consequences relating to Market Renewal. For example, could pressure be brought to bear against self-generation to avoid revenue leakage from the system – perhaps an outright ban on rooftop solar? This issue could reflect another component of the intergenerational equity debate – the propriety of allowing some customers, who are currently connected and receiving electricity services, to disconnect from the grid that previous/current generations have largely paid for and enabled?

BLG's Electricity Markets Group will continue to monitor developments related to the Fair Hydro Plan and we would be pleased to discuss how this latest industry development may impact your business.

Par

J. Mark Rodger

Services

Énergie – Électricité

BLG | Vos avocats au Canada

Borden Ladner Gervais S.E.N.C.R.L., S.R.L. (BLG) est le plus grand cabinet d'avocats canadien véritablement multiservices. À ce titre, il offre des conseils juridiques pratiques à des clients d'ici et d'ailleurs dans plus de domaines et de secteurs que tout autre cabinet canadien. Comptant plus de 725 avocats, agents de propriété intellectuelle et autres professionnels, BLG répond aux besoins juridiques d'entreprises et d'institutions au pays comme à l'étranger pour ce qui touche les fusions et acquisitions, les marchés financiers, les différends et le financement ou encore l'enregistrement de brevets et de marques de commerce.

blg.com

Bureaux BLG

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000, rue De La Gauchetière Ouest
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749