Whither Ontario Hydro?

A Picture of Restructuring in Mid-Flight

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On November 6, 1997, the Ontario provincial government announced a "White Paper" policy statement expressing its decision that Ontario Hydro would be restructured and an open, competitive power market introduced in the year 2000. The decision to restructure Ontario Hydro came after years of declining financial performance, operational deficiencies, and internal organizational reforms. The electricity sector reform effort in Ontario will have a significant influence on the future of the power sector in most of the rest of Canada.
Description of Ontario Hydro

Ontario Hydro is the largest utility in Canada in terms of revenues, which were $8,886 million (CND) in 1996. Ontario Hydro, as the first provincially-owned electric utility in Canada, was the model for most of the nation's power sector.

Ontario Hydro is a generation and transmission, electric only utility that also provides retail service to about one million rural direct retail customers (10% of Ontario's population) and most of the largest industrial customers. It owns and operates hydro-electric units, conventional simple cycle fossil units (almost all coal), and nuclear units. It has 20 nuclear units, all of the CANDU pressurized heavy water design. The operable number of units by the end of March will drop from 19 where it was last fall to 12 or 14. Additional substantial nuclear capacity cuts within five years appear unavoidable.

In 1998, total domestic requirements are forecast by Ontario Hydro to be 142 TWh, of which 44% is forecast to come from nuclear production, 25% from hydro-electric, 5-10% from purchased generation (mostly gas cogen under long term contracts and short term imports), and the remainder from coal and oil-fired units.

Ontario Hydro's long term debt is roughly $30 billion CND ($20.7 billion US), more than two thirds of which is attributable to nuclear spending. The debt is fully guaranteed by the provincial government. Ontario Hydro's estimate of its nuclear waste disposal and decommissioning liability is $15 billion (CND) in 1996 dollars. Its balance sheet is eroding. Writeoffs in the last three reported years (1997 has not been reported yet) have totalled $7.1 billion (CND) offset by $2.2 billion in before-writeoffs-profits. I anticipate even larger writeoffs and lower "profits" in the near future. Its rates are the highest in the industrialized parts of Canada and by my estimate 30% over market.

Nuclear performance is sharply declining—it peaked at 64% of the fuel mix in 1994. The costs
for running and fixing the remaining 12 reactors was last fall increased by $1.6 billion (CND) to pay for urgent upgrades.

Ontario Hydro’s sales volume peaked in 1989 and has yet to recover to that level despite significant economic expansion in Ontario since then. The cause of the decline was a 20% real rate increase in the early 1990s and also gas deregulation which has brought the cost of that competing fuel down sharply. Until six years ago, the utility was still planning to build 10 more nuclear units.

The strength of Ontario Hydro’s legal monopoly is moot, but so far none of its customers has tested the matter in the courts.

Until last year, the utility claimed to have over 3000 MW of excess capacity. Recently announced nuclear "lay-ups" have created some question about its load meeting capability during peak periods for the next several years.

The concept of "checks and balances" does not generally apply to the electricity sector in Canada for many complex historical, cultural, and legal reasons. The legal and administrative power Ontario Hydro currently enjoys include:

- the utility’s own board of directors has the authority to set its own rates and lately has done so for cogen avoidance rates without any public process and total secrecy about the prices,
- the board sets and approves its own capital and operating budgets,
- the board regulates the rates of every distribution utility in Ontario (except one little one) and does so in secret and without the distributor having any legal rights of appeal, and
- the board is the legal regulator of electrical equipment safety in Ontario and has recently used that power to harass a tiny district heating cogen competitor.
The current chairman of Ontario, like most previously, is a close political confidant of the provincial premier.

White Paper and the Reform Process

The key elements of Ontario's "White Paper" electricity policy are:

- customer choice for all regardless of size in the year 2000;
- separation of generation and transmission, and a general commitment to separation of monopoly and competitive enterprises;
- no commitment to privatization "at this time" and maintenance of all generating assets in one provincially-owned corporation;
- independent regulation of rates for transmission and distribution services;
- independent management of the transmission grid to allow non-discriminatory access for producers and consumers;
- competition among generation firms;
- an end to the current subsidies to the public power sector—taxpayer backed loan guarantees, tax holidays, and permanent dividend holidays.

The reform process is to be overseen by three committees: the Electricity Restructuring Committee of Deputy Ministers, composed of senior government bureaucrats from the departments of the Cabinet Office, Finance, and Energy; the Electricity Transition Committee, composed of the Minister of Energy and the heads of various stakeholders organizations; and, the Market Design Committee (MDC).

The MDC is the public face of the restructuring effort. The composition of the MDC was announced last week, which is two months behind schedule. The delay in announcing the MDC suggests weakened resolve on behalf of the provincial government. The MDC is chaired by
three respected academics. The remainder is a group of 14 people drawn from various organizations with interests in the electricity sector including Ontario Hydro, industrial power users, municipal utilities, and independent power producers now selling on long term contracts to Ontario Hydro. Our organization has been refused access the MDC. None of the MDC members have international electricity restructuring experience. A research secretariate of the MDC is expected to acquire support from consultants with international experience.

Key Reform Issues

There are four key deficiencies in White Paper: failure to endorse privatization, a reform which is necessary but politically delicate; failure to break up Ontario Hydro’s generation assets; absence of a coherent financial plan; and failure to commit to enhanced environmental controls, a deficiency which could undermine public support for the reform process.

A key strength of the White Paper is the decision to withdraw the loan guarantee for future borrowing. Applied properly, this policy could cause incremental privatization without the government ever using the word. If Ontario Hydro loses its loan guarantees and if future liabilities are made subsidiary to guaranteed debt, its borrowing could become so expensive that it would give the utility a strong incentive to liquidate undervalued assets in order to acquire cash for financing.

The main negative impact of Ontario’s highly centralized electricity monopoly has not been monopoly rents being extracted by owners, rather the negative impacts have been stultified innovation, squandered capital, unnecessary technological risk, and inefficient pricing. The advent of a competitive power market is likely to reveal significant volatility in price. Opponents of competition are likely to use this as an argument against reform.

The demonopolization process is vulnerable to many potential factors. A provincial election will
be called in the middle of the process. The MDC may not prove capable of implementing the "White Paper's" policies. There are clear indications that Ontario Hydro is vigorously seeking to defend its ability to control the factors that sustain it and to retain as much of the status quo as possible, as the historical record shows it has done in the past.

Creating an ISO (called an Independent Market Operator in the White Paper) will be extremely challenging. A proto-ISO (called the Central Market Operator) has been established but is under the control of Ontario Hydro. Energy Probe has been pressing for a voluntary spot market with some kind of scheduling arrangement for those opting out. The trade groups representing major industrial users and the municipal utilities have opposed our dual market proposal. The representatives for the industrials are pushing for a "pure bilateral" market and the representatives of the municipal utilities are pushing for a mandatory purchasing cooperative for all municipal utilities operated by the municipal utility trade group. Enron is advocating a dual market.

Recently, British Energy and secondarily Duke Energy have expressed an interest in taking an equity interest in the nuclear operations. These discussions improve the prospects for generation unbundling because they would lead to a separation of the nuclear assets from the conventional generating assets. In addition, Ontario Hydro's main union, which had been the leading opponent of privatization, has moderated its stance on privatization in light of the prospect of an equity infusion in their favoured nuclear units. If the difficulties of nuclear privatization could be overcome, the prospects for further privatization would be enhanced.

For about a decade starting in 1916, when Ontario Hydro was gaining its modern powers, the utility was attacked by a now forgotten but prescient University of Toronto professor of political economy, James Mavor. Arguing from first principles, Mavor forecast many of the ills that befell the utility, among them its unaccountability, its fatal blindness to risk, its failure to report real depreciation costs, a continual management crisis, and the scourge inefficient pricing with its consequences for distorted demand.
What is different 80 years on and can we succeed where Mavor failed? The ongoing crisis in the nuclear program and the resulting rate impacts are part of what is driving the reform agenda. Maurice Strong’s tenure in the chairmanship from 1993 to 1995, helped to bring some objective analysis to the issue. Strong made it clear in official circles that the monopoly they took for granted might not hold up in court or on customer premises. The defection of the large industrial customers in the early 1990's from their traditional policy role as Ontario Hydro supporters was also significant. The influential 1995 expert review of the electricity industry, headed by one of Canada’s most respected elder statesman, Donald Macdonald, was another milestone. The influence of our own little organization is difficult to trace. 18 years ago we published a plan to separate generation from transmission and to make the customer sovereign. Long before that and ever since, we have been continually bringing to public attention deficiencies in the existing system. Even today, we are the only public proponents of privatization. Public support for Ontario Hydro has steadily weakened.

The tenuous threads of an open, competitive system are strengthening. We should be cautiously optimistic about someday succeeding, but many battles lie ahead.

Thank you.