Financial Accountability Office Report: Fiscal Impact of the Province's Fair Hydro Plan

Office of the Budget
MINISTRY of FINANCE

May 23, 2017

ISSUE

- On Wednesday May 24, 2017, the Financial Accountability Office of Ontario (FAO) is scheduled to publicly release a report that assesses the fiscal impact of the Province's Fair Hydro Plan (FHP).

- In undertaking this research project, the FAO's report was guided by a number of questions including:
  - What is the fiscal impact of the FHP on the Province's long-term finances over 30 years?
  - What is the impact on electricity costs and electricity ratepayers over 30 years?
  - A review of the financing structure of the FHP, including the electricity cost refinancing.

KEY MESSAGES (FOR THE MINISTER OF FINANCE)

- The Fair Hydro Plan, which includes the Ontario Rebate for Electricity Consumers equivalent to the 8 per cent provincial portion of the HST, will lower electricity bills by 25 per cent on average for residential consumers in the province.
- About 500,000 small businesses and farms will also benefit from the initiative.

- We are also proposing to lower energy costs by expanding access to natural gas to communities that are currently underserved, including rural, northern Ontario and First Nation communities.

- Reducing electricity costs is part of Ontario's plan to create jobs, grow our economy and help people in their everyday lives.

- [INCLUDE ADDITIONAL KEY MESSAGES AS NECESSARY]

SUMMARY OF MOF/TBS KEY CONCERNS/COMMENTS ON THE FAO'S REPORT

- [TO BE UPDATED AS NECESSARY] MOF/TBS concerns/comments on the report can be categorized in three buckets, as follows:
  - **Accounting Treatment** – the way the accounting treatment of the regulatory / investment asset is described in the draft report is incomplete and inaccurate in regards to Public Sector Accounting Standards (PSAS) references.
  - **Financing Costs and Interest Rate Spread Assumptions** – the FAO's estimates are based on an illustrative assumed 5 per cent interest rate, while actual financing costs may differ. The FAO draft report assumes that the 5% is a weighted average of Provincial (at 3.5 %) and OPG Trust borrowing costs (at 6.2%) – and the assumed 270 basis points interest rate spread used to calculate their borrowing cost estimates is unrealistically high, which overstates the likely total cost of borrowing through the OPG Trust.
  - **Treatment of Electricity Relief Programs** – the FAO's assumption that government support for these programs will conclude in 2020-21 is not plausible, given that the legislation introduced in the House transfers these programs from the rate-base to government-funded.

HIGH-LEVEL SUMMARY

- The FAO report provides a brief overview of the FHP, which includes the following initiatives:
    - **Harmonized Sales Tax (HST) Rebate**: A rebate to residential ratepayers for an amount equal to the 8% provincial portion of the HST on electricity bills.
    - **Electricity Cost Refinancing**: the Province is proposing to borrow an average of $2.5B per year through 2027 to pay a portion of electricity costs to temporarily reduce the amount paid by eligible ratepayers. The Province would recover the borrowed funds, including interest, from ratepayers over an estimated 18-year period starting in 2028.
    - **Adjusting Electricity Relief Programs**: currently the cost of the Rural or Remote Rate Protection Program (RRRP) and Ontario Electricity Support Program (OESP) is recovered from all electricity ratepayers through the cost of electricity. The FHP would transfer the cost of these programs from electricity bills to the Province.

- The FAO estimates that the **FHP will have a total net cost of $21B over a 29-year time period (2017-2045)**, based on the following:
    - Total **cost to the Province** of approximately **$45B;**
    - **Net savings** to **eligible electricity ratepayers of $24B**.

<u>RISKS FLAGGED BY THE FAO</u>

- The FAO states that if the Province **funds the cost of the FHP through debt**, the total cost to the taxpayer could increase to between $69B and $93B.

- The FAO flags risks which would result in higher costs to ratepayers during the repayment period related to **higher-than-expected:**
    - **Ratepayer demand for electricity;**
    - **Costs to generate/deliver electricity; and/or**
    - **Interest rates on borrowed funds**.
- The FAO also flags **risks related to the proposed accounting treatment** of the electricity cost refinancing component that could result in additional costs to the Province of $26B between 2017-18 and 2027-28.

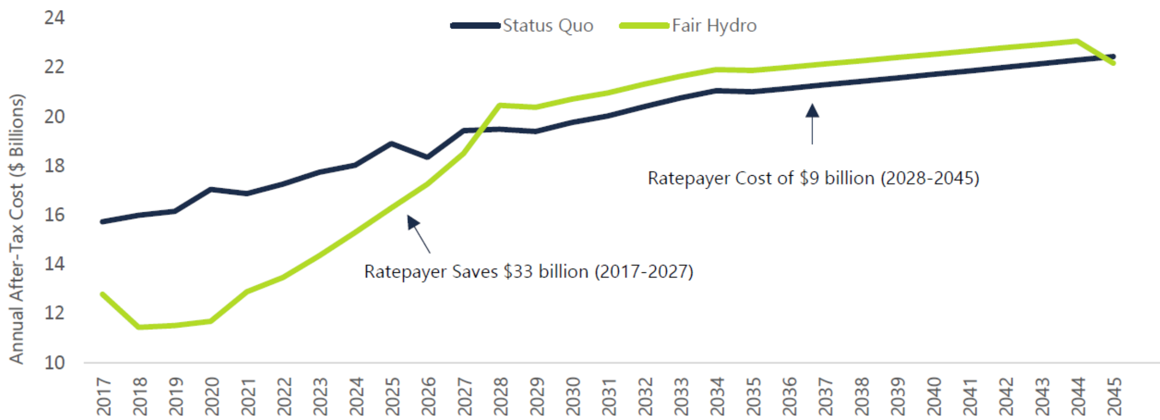
<u>IMPACT ON RATEPAYERS – NET SAVINGS OF $24B</u>

- The FAO projects that the FHP will result in total net savings to ratepayers of $24B over 29 years:
    - From 2017 to 2027 – costs will be lower under the FHP compared to the status quo (for a total savings of $33B), and
    - From 2028 to 2045* – costs will be higher under the FHP compared to the status quo (for a total cost of $9B).

    * Under the electricity cost refinancing plan, ratepayers do not begin repayment until 10 years after borrowing commences.

Figure 3-1 shows the FAO's estimated impact of the FHP on eligible ratepayer electricity costs relative to a status quo scenario

Figure 3-1: FAO's Estimated Impact of the FHP on Eligible Ratepayer Electricity Costs



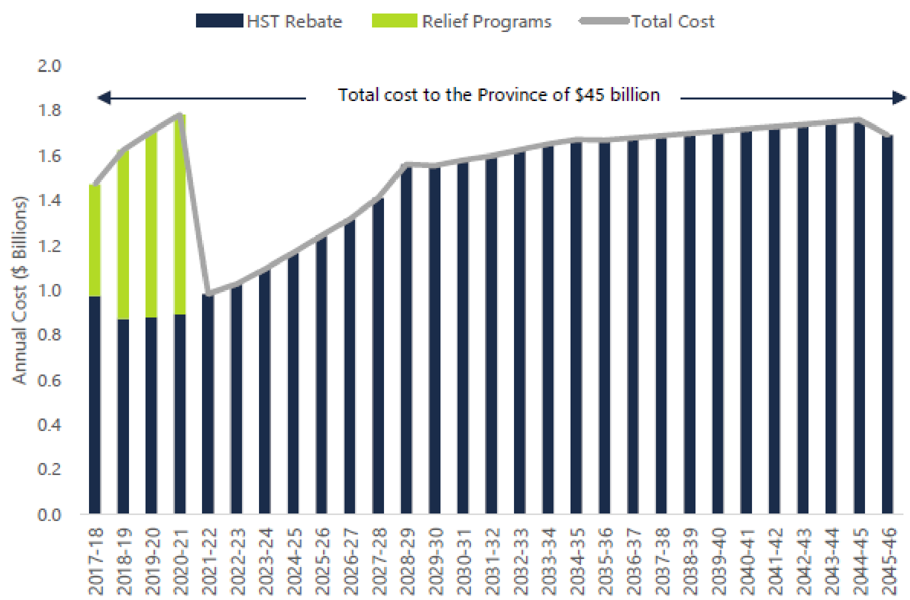
Source: FAO analysis of Provincial information.

- The estimated $24B savings for eligible electricity ratepayers under the FHP is made up of the following components:
  - HST Rebate: savings of $42B.
  - Electricity Cost Refinancing: cost of $21B.
  - Adjusting Electricity Relief Programs: savings of $3B.

IMPACT ON THE PROVINCE'S FINANCES – TOTAL COSTS OF $45B

- The FAO estimates that the FHP will cost the Province approximately $45B over 29 years. The cost estimate is made up of the following components:
  - HST Rebate: cost of $42B.
  - Adjusting Electricity Relief Programs: cost of $3B.
- Figure 3-3 shows the FAO's estimated annual cost of the FHP to the Province. This estimate assumes that the Province:
  - Will provide the HST Rebate for the entire time period (2017-2045), and
  - Will not fund the electricity relief programs after 2020-21.

Figure 3-3: FAO's Estimated Annual Cost of the FHP to the Province, 2017-18 to 2045-46

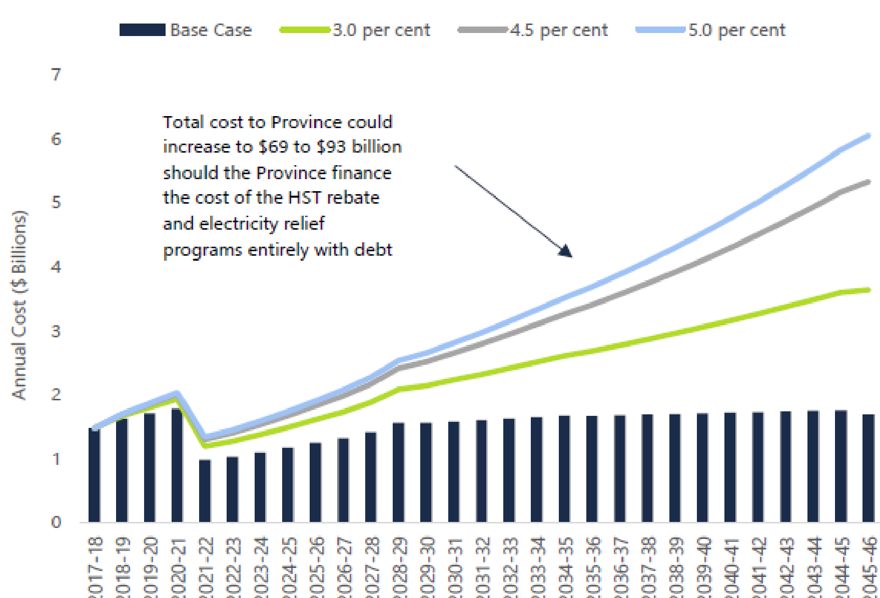


Note: Provincial funding for electricity relief programs is assumed to end after 2020-21 based on the Province's announced commitments regarding the FHP and information provided by the Province to the FAO.
Source: FAO analysis of Provincial information.

- If the Province funds the electricity relief programs, along with the HST rebate, by borrowing over the 29-year period, the FAO projects that costs to the Province would increase by $24B to $48B (from $45B to between $69B and $93B).

  Figure 3-4 shows the FAO's estimated annual cost of the FHP to the Province under different assumed interest rate scenarios.

Figure 3-4: FAO's Estimated Annual Cost of the FHP to the Province, 2017-18 to 2045-46



Source: FAO analysis of Provincial information

ACCOUNTING TREATMENT

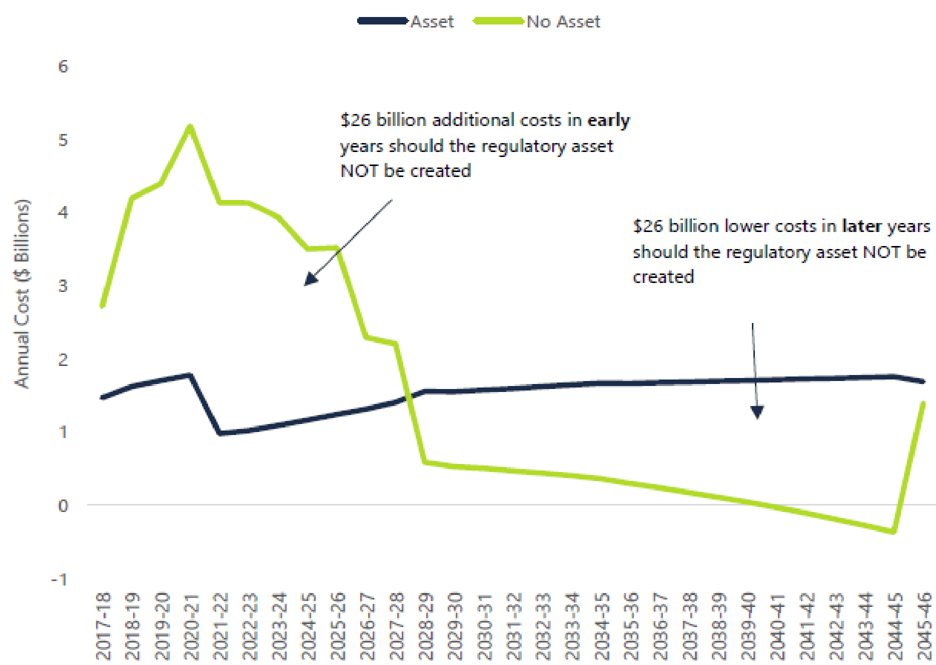
- The FAO states that the FHP involves the use of a complicated accounting structure that will create a regulatory / investment asset under which the electricity cost refinancing component will:
  - Increase gross debt by approximately $26B by 2027-28;
  - Create an obligation for ratepayers to repay the OPG Trust approximately $26B, thereby
  - Not impacting the annual surplus / deficit or net debt of the Province.

- The FAO is uncertain as to whether the creation and recording of the regulatory / investment asset, as proposed under the electricity cost refinancing initiative, is consistent with Canadian public sector accounting standards (PSAS).

- If the regulatory / investment asset does not meet PSAS, the FAO estimates that the electricity cost refinancing initiative would result in $26B in additional costs to the Province from 2017-18 to 2027-28 and $26B in savings to the Province from 2028-29 to 2045-46.

  Figure 4-1 shows the FAO's estimated annual cost to the Province of the FHP under scenarios in which the regulatory / investment asset is created or not created.

Figure 4-1: FAO's Estimated Annual Cost to the Province of the FHP if the Regulatory / Investment Asset is Created or Not Created, 2017-18 to 2045-46



Source: FAO analysis of Provincial information