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# Stranded Debt, Residual Stranded Debt and the Debt Retirement Charge

Corporate and Electricity Finance Division
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# Key Messages

- The restructuring of the former Ontario Hydro resulted in $20.9 bn of stranded debt as at April 1, 1999.
- **Residual stranded debt** is the stranded debt minus the present value of projected future revenues to OEFC. The initial estimated residual stranded debt, as at April 1, 1999, was $7.8 billion.
- To help OEFC, the legal successor to Ontario Hydro, to service and retire this stranded debt, the Province dedicates revenues it receives from the electricity sector to OEFC:
  - payments in lieu of taxes and the Gross Revenue Charge from OPG, Hydro One and municipal electricity utilities;
  - Electricity Sector Dedicated Income from the Province in respect of the net incomes of OPG and Hydro One; and
  - the Debt Retirement Charge (DRC) paid by electricity users.

**<u>Stranded Debt Paydown:</u>**

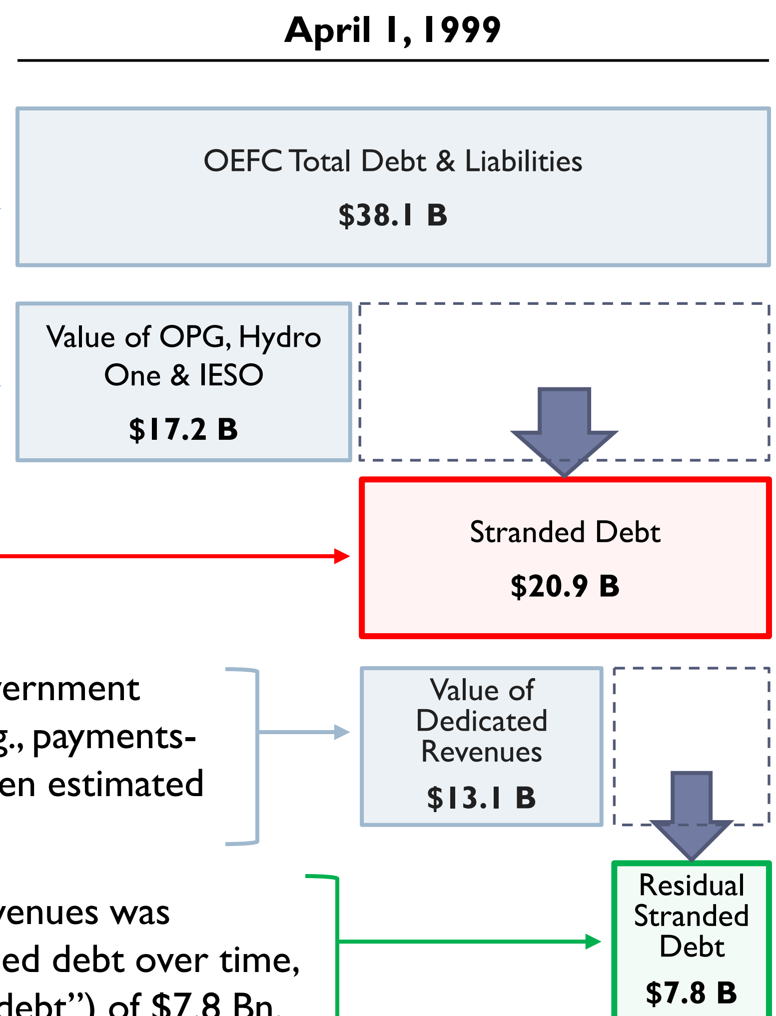
- After an increase in stranded debt under the previous government, electricity sector reforms have put the stranded debt recovery plan back on track and paid down stranded debt for ten consecutive years, from $20.6 billion as at March 31, 2004 to $9.8 billion as at March 31, 2014.

**<u>Transparency:</u>**

- **Residual Stranded Debt paydown:** In accordance with a regulation introduced in May 2012, the Minister of Finance reports annually on the residual stranded debt. The residual stranded debt has been determined to be $2.6 billion as at March 31, 2014. This is a decrease of $9.3 billion from an estimated peak of $11.9 billion as at March 31, 2004.
  - The Electricity Act, 1998, allows for the DRC to be paid until the Minister of Finance determines that the residual stranded debt is retired.
- **OEFC's financial statements are released every year** as part of Public Accounts: OEFC results are fully consolidated on a line-by-line basis into the Province's accounts.
- The Auditor General audits OEFC's annual financial statements and has provided a clean opinion every year since the initial 1999-2000 financial statements. In addition, the Auditor General's 2012 and 2013 Annual Reports noted that the Auditor was pleased to see an increased level of transparency with respect to public reporting on the residual stranded debt.

# Residual Stranded Debt: April 1, 1999

- Stranded debt and residual stranded debt arose out of restructuring of the old Ontario Hydro on April 1, 1999, under the *Electricity Act, 1998.*
- Ontario Electricity Financial Corporation (OEFC) is the legal continuation of the old Ontario Hydro, and inherited its debt and certain liabilities, totalling $38.1 Bn.
- The old Ontario Hydro's assets were re-valued at $17.2 Bn, to reflect the new structure of the electricity sector.
- This left a shortfall or "stranded debt" of $20.9 Bn as at April 1, 1999.
- To help OEFC service and retire this stranded debt, the government dedicates revenues from the electricity sector to OEFC {e.g., payments-in-lieu of taxes (PILs) from OPG and Hydro One}, with a then estimated present value of $13.1 Bn.
- The estimated value of these projected future dedicated revenues was estimated to be insufficient to completely pay off the stranded debt over time, leaving a difference (the initial estimated "residual stranded debt") of $7.8 Bn.



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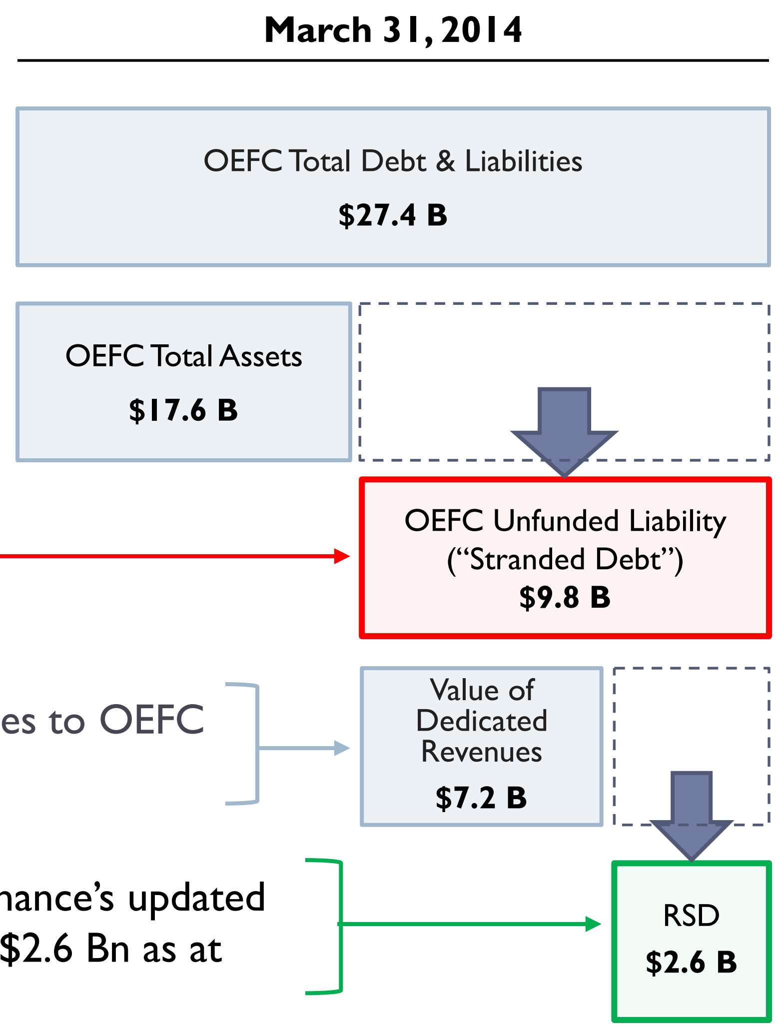
# Residual Stranded Debt: March 31, 2014

- "Residual stranded debt" is defined under the Electricity Act and Ontario Regulation 89/12 as the stranded debt less the estimated present value of projected future PILs, gross revenue charge (GRC), and electricity sector dedicated income (ESDI) to be paid to OEFC.

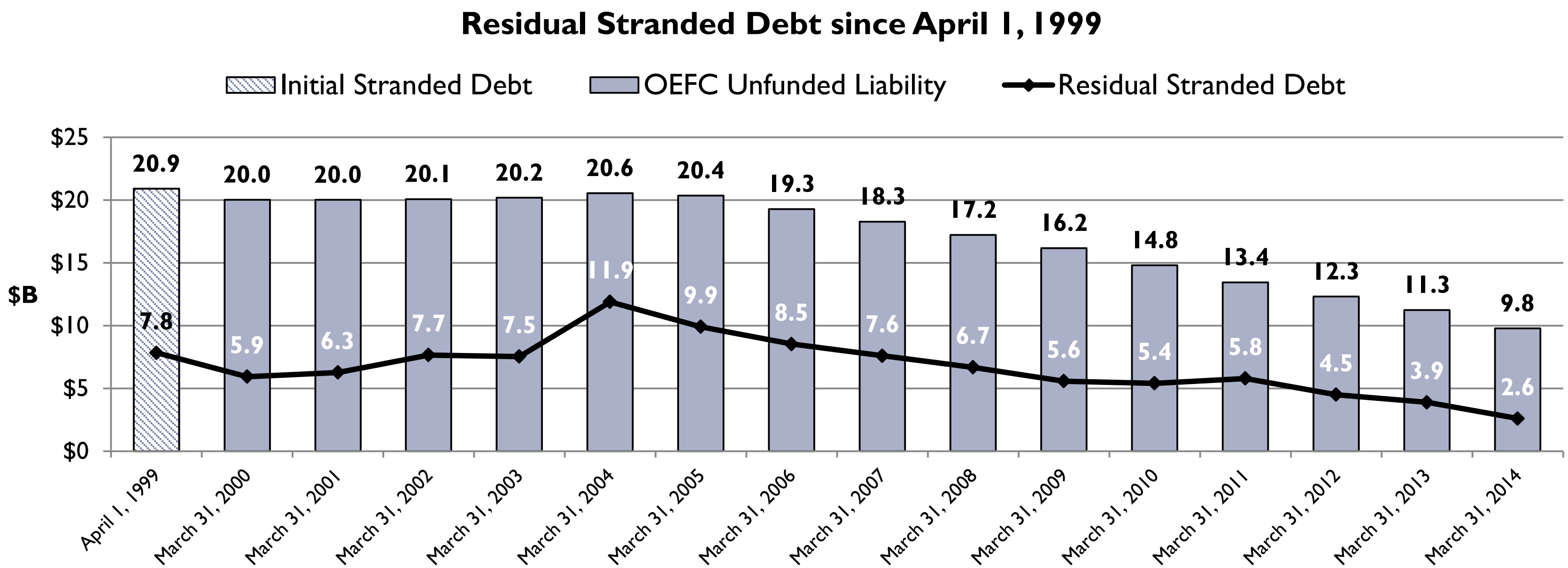
- The residual stranded debt is, therefore, not a fixed, one-time determination and is subject to risk and uncertainty, and is affected by the:
  - updated amount of stranded debt (down to $9.8 Bn, as at March 31, 2014)
  - updated estimated value of future dedicated revenues to OEFC (at $7.2 B, as at March 31, 2014).

- This resulted, under O. Reg. 89/12, in the Minster of Finance's updated annual determination of the residual stranded debt of $2.6 Bn as at March 31, 2014.



# Residual Stranded Debt since April 1, 1999

- The following chart illustrates the path of residual stranded debt from the initial reported value of $7.8 billion as at April 1, 1999, to $3.6 billion as at March 31, 2014.
  - To March 31, 2014, RSD has declined by $9.3 billion since its estimated peak of $11.9 billion as at March 31, 2004.
  - Residual stranded debt increased to a peak of $11.9 billion as at March 31, 2004 primarily due to the electricity price freeze and a reduction in the expected future dedicated revenues to be paid to OEFC.




*Note: Other than the initial reported value in 1999, residual stranded debt has only been officially determined since March 31, 2011, under O. Reg. 89/12. The previous residual stranded debt values are estimates and were first included in the 2012 Ontario Budget.*

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# Asset Optimization: Impact on the Province and OEFC

Note: Under the Electricity Act, net proceeds to the Province from the sale of securities in Hydro One are to be paid to OEFC.

**Change in Stranded Debt**

**(Up or Down depending on sale value)**

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**2. Loss of Future Dedicated Revenues**

- Sale would also result in lost future Hydro One PILs, dedicated income
- Impact from reduction in present value, of future PILs & dedicated income related to Hydro One assets.

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**PV of Dedicated Revenues**

↓

**1. Sale Impacts**

- Impact on OEFC from adjusted net proceeds from sale, impact on Hydro One results in year of sale
- Could affect retirement date of the RSD, which would affect DRC & dedicated income revenue to OEFC

=

**RSD**

? (↑/↓)

**Impact on RSD uncertain:**
Upfront impacts from sale would ***decrease stranded debt***, but offset by ***decrease to the PV of dedicated revenues*** to OEFC

**H1 and Brampton under different ownership would be subject to Provincial corporate income taxes, but it is assumed that these taxes would be effectively eliminated for a significant period of time due to tax shield from revaluation of assets and tax planning activities going forard.*

# Appendix

# Background

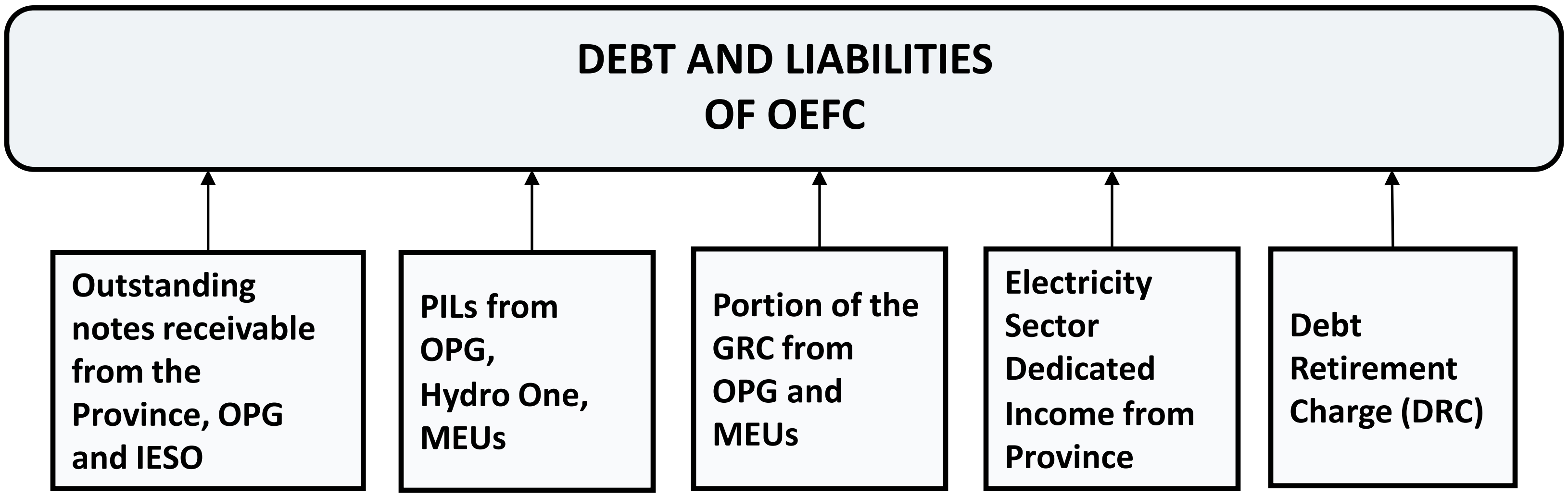
- The *Electricity Act, 1998*, provides for the debt retirement charge (DRC) to be paid by consumers until the Minister of Finance determines that the residual stranded debt is retired.
- Under Ontario Regulation 89/12, the Minister of Finance is to determine the amount of the residual stranded debt for each fiscal year end and publish in a notice in The Ontario Gazette.
- The residual stranded debt determination as at March 31, 2014, of $2.6 billion was published in the 2014 Ontario Economic Outlook and Fiscal Review (Fall Economic Statement or FES).
  - The 2014 FES also contained an estimate for when the residual stranded debt will likely be retired which is estimated to occur by the end of 2018.
- The government is moving forward with removing the DRC cost from residential users' electricity bills after December 31, 2015, once the Ontario Clean Energy Benefit ends. The DRC is to remain on all other electricity users' bills until the residual stranded debt is retired.

# Financial Restructuring – April 1, 1999


- Ontario Hydro was restructured into five successor companies on April 1, 1999
  - OPG, Hydro One, and Independent Electricity System Operator (IESO) acquired Ontario Hydro assets by issuing a $17.2 billion in debt to OEFC
    - Ontario Power Generation operates the electricity generating assets of Ontario Hydro
    - Hydro One operates electricity transmission and distribution in Ontario
    - OEFC has the responsibility for servicing and retiring the former Ontario Hydro's debt and managing certain other assets and liabilities
    - The Independent Electricity System Operator (IESO) is responsible for operating the electricity market and directing the operation of the bulk electrical system in the province of Ontario
    - The Electrical Safety Authority's (ESA) role is to improve electrical safety for the benefit of all Ontarians
- As part of the restructuring, the Province commercialized OPG and Hydro One and became the sole shareholder through a debt-for-equity swap
- OPG was valued at $8.5 billion, with a 40% debt, 60% equity capital structure ($3.4 billion debt, $5.1 billion equity)
- Hydro One was valued at $8.6 billion, with 60% debt, 36% common and 4% preferred equity capital structure for its regulated transmission and distribution ($4.8 billion debt, $3.8 billion total equity, including equity in unregulated businesses)

# OEFC Debt Repayment Plan

- As the legal continuation of the former Ontario Hydro, OEFC services and retires the debt and other liabilities through revenues and cash flows from the following sources within the electricity sector:




- There is no ear-marking of specific revenues to any individual portion of OEFC's debt and liabilities, and, there is no segregation of OEFC's debt and liabilities into portions that are either "stranded debt" or "residual stranded debt"

# Debt Retirement Charge (DRC)

- Since the estimated value of these future dedicated revenues alone were estimated to be insufficient to completely pay off the stranded debt over time, the *Electricity Act, 1998,* provided for the DRC, to be paid to OEFC.

- The DRC is a charge payable on electricity consumed in Ontario, at 0.7 cents per kilowatt hour (kWh) of electricity consumed (with some exceptions). The DRC collected in 2012-13 was $939 million.

- The *Electricity Act, 1998*, allows for the DRC to be paid by consumers until the Minister of Finance determines that the residual stranded debt is retired (i.e., when the projected future dedicated revenues are estimated to be sufficient to pay off the stranded debt).
  - On April 23, 2014, the government announced that it is proposing to remove the DRC cost from residential users' electricity bills after December 31, 2015. The DRC is to remain on all other electricity users' bills until the residual stranded debt is retired.

| Typical Residential Bill – 2014* | 800 kWh |
|---|---|
| Generation, Delivery and Regulatory | $128.91 |
| Debt Retirement Charge (800 kWh @0.7 ¢/kWh) | $5.60 |
| Tax | $17.49 |
| Subtotal | $152.00 |
| Less: OCEB | $15.20 |
| Final Bill | $136.80 |

*Consumers pay the DRC to help OEFC service and pay down the stranded debt until the value of future dedicated electricity sector revenues are estimated to be sufficient to offset the remaining stranded debt; i.e., when the estimated residual stranded debt is zero.*

*The DRC for a typical residential user currently represents about 4 per cent of the final bill, as illustrated above.*

**Illustrative monthly residential electricity bill. Total before OCEB sourced from 2014 typical monthly residential electricity bill projection, from 2013 Long-Term Energy Plan.*

# Introduction of O. Reg. 89/12

- On May 15, 2012, the government filed the regulation under the Electricity Act, 1998, to provide transparency and reporting requirements on the determination of residual stranded debt each fiscal year.

- In accordance with the *Electricity Act, 1998*, and Ontario Regulation 89/12, the residual stranded debt is the stranded debt minus the present value of projected future PILs, Gross Revenue Charge (GRC), and electricity sector dedicated income to be paid to OEFC.

- The residual stranded debt is not a fixed, one-time determination and is affected by
  - I. changes in the amount of stranded debt, and
  - II. changes in the estimated future dedicated revenues to OEFC.

- Since the introduction of Regulation 89/12, the Auditor General's 2012 and 2013 Annual Reports noted that the Auditor was pleased to see an increased level of transparency with respect to public reporting on the residual stranded debt since the $7.8 billion estimate on April 1,1999.

- The Auditor General audits OEFC's annual financial statements and has provided an unqualified opinion every year since the initial 1999-2000 financial statements.

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# OEFC Model Inputs and Calculations

- To model future revenues to OEFC, staff rely on inputs from a variety of sources. Data sources used in OEFC modelling include:
    - OPG's business plan and long-term model,
    - Hydro One's business plan and long-term projections,
    - OEFC borrowing and lending reports, and
    - Other various sources reflecting significant electricity sector or financial policy changes (e.g., Ontario Budget).
- Staff make any necessary updates or adjustments to the long-run financial projects provided by the companies for the purposes of establishing the residual stranded debt estimate.
- Sensitivity and scenario analysis is then performed on the financial projections, with the results used to estimate the "defeasance range" (the estimated date range for the end of the residual stranded debt).
    - For example, staff will look at the impacts of over or under performance by the electricity agencies, various cost recovery scenarios, etc.