

# Selling Off Toronto Hydro:

Private Sector Gain, Consumer Pain

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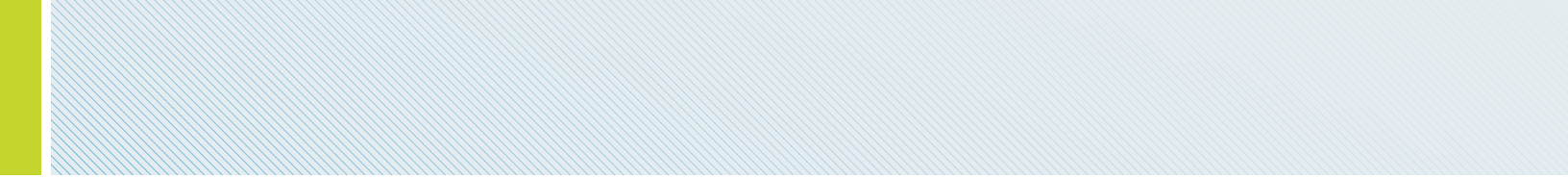
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# Selling Off Toronto Hydro:

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## Introduction

In a bid to pay for much needed infrastructure, Mayor John Tory wants city council to consider selling off part of Toronto Hydro.<sup>1</sup> Recent media reports suggest that the utility has hired the mayor's political allies to make the case to Torontonians for privatization<sup>2</sup> and it appears that the Toronto Hydro board and CEO are making decisions that will support the case for privatization.<sup>3,4</sup>

This paper analyzes the gap between the case for privatizing hydro and the potential implications for the city's fiscal coffers, city leadership on climate change, and consumer costs for hydro services.

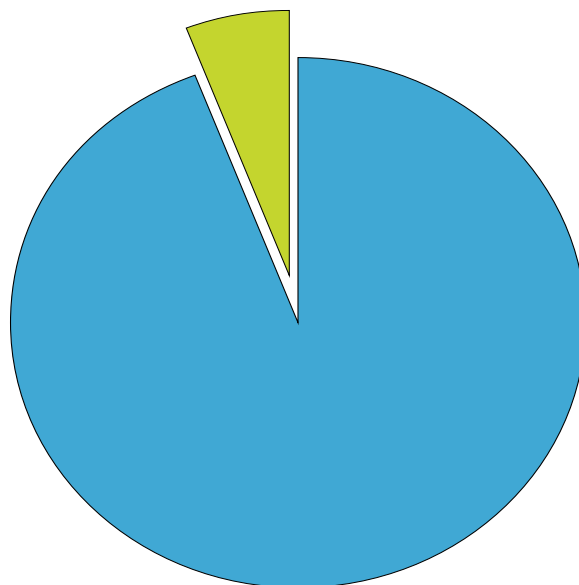
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## The impact on infrastructure funding

The city manager has indicated that the city has more than \$29 billion in unfunded capital projects, on top of any capital needs of Toronto Hydro.<sup>5</sup> A one-time injection of cash through a partial sell-off of Toronto Hydro will not address the city's need for ongoing revenues to pay for them. These costs are long-term and ongoing. They need a consistent source of funds to pay for them.

The mayor has committed to maintain majority control of Toronto Hydro. That suggests up to 49 per cent of the utility could be taken over by private interests. There have been estimates in the media that suggest a sale of 49 per cent of Toronto Hydro could be worth between \$1.5 and \$1.9 billion.<sup>6,7</sup> At best, this sell-off would provide 6.8 per cent of unfunded capital needs — a drop in the bucket. In either scenario, city council will have to find a more

**FIGURE 1** Share of unfunded capital projects covered by 49 per cent Toronto Hydro privatization



**Source** City Manager's Report and the Globe and Mail.

sustainable source of funding for these projects, as the city's capital funding shortfall would remain above \$27 billion.

*Figure 1* shows the sliver of proceeds from losing 49 per cent of the control over Toronto Hydro.

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## The impact on the city's bottom line

Toronto Hydro is a very good investment for the city. The average return on equity for Toronto Hydro over the last five years was nine per cent. The average dividend yield was 3.9 per cent.<sup>8</sup> The returns that were not paid out in dividends have been used to finance capital expenditures needed to renew and expand Toronto Hydro's infrastructure.

Year in and year out, this public asset provides valuable dividends to the city. Over the last five years, those dividends totalled \$241 million.

These returns are higher than the city's long-term interest costs. They are also higher than the return on stocks or bonds over the same period.

This week, the Toronto Hydro board reduced the dividend payments to the city by more than 50 per cent.<sup>9</sup> The CEO of Toronto Hydro has denied that this decision is related to privatization. Given this move has come out of left field, it's hard to imagine that it isn't related to the privatization discus-

sion coming before council. In an OEB decision about Toronto Hydro rates last year, it approved a \$2.25 billion investment plan that would be funded within the utility's current rate structure and plans. There was no talk then about cutting the city's dividend.

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## Transaction costs

There are large transaction costs associated with privatization that will line the pockets of bankers and consultants on Bay Street. Cost estimates for an initial public offering are up to 10 per cent of the proceeds, along with \$500,000 to \$1 million in legal fees and other costs.<sup>10</sup> Given the complex regulatory nature of such a sale, this cost would likely be at the high end of the range: a price tag that could be over \$150 million.

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## Hydro sell-off and policy flexibility

How would selling off up to 49 per cent of control over Toronto Hydro affect the utility — and, by extension, elected officials at city hall — in terms of the ability of a public institution to act in the best interests of Torontonians?

Currently, all Toronto Hydro directors are appointed by the City of Toronto, which is the sole shareholder. If it is partially sold off, representatives of the new investors will join Toronto Hydro's board. Directors who represent private shareholders will have a mandate to maximize returns. They are likely to direct management to run Toronto Hydro with a greater focus on returns for their own shareholders rather than making concern for Toronto's residents the main priority.

This will likely increase hydro prices for Toronto customers, but it could have other impacts as well. The Toronto Hydro Board of Directors can influence a wide range of policies: energy conservation, affordability of hydro rates, employment practices, and the importance placed on reliability of the electricity supply. Even partial privatization of this public utility reduces the ability of the city to operate it in the public interest.

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## The hollow promise of privatization

Both in Canada and internationally, the failure of privatization to deliver on its promise, combined with an increased desire for better policy re-

sponsiveness, has contributed to a return to public control over vital services such as electricity.

In Germany, for instance, 170 municipalities have brought energy services back into public sector control.<sup>11</sup> A recent report from the Columbia Institute described the reasons for reversing privatization including: better quality control, flexibility, efficiency in operations, better staff morale, and better support for vulnerable citizens. When services are brought back under public oversight, local governments re-establish community control of public service delivery.<sup>12</sup>

The limitations of privatization are even more clearly described by social justice movements for energy democracy. These movements are focused on a fair energy system, including universal access, fair prices and secure, unionized and well-paid jobs. Their focus is on an energy system that works in the public interest, including social and environmental goals.<sup>13</sup>

An important further caution on the city's ability to maintain control over its policy flexibility: under NAFTA's investment protections, and if the recently signed Comprehensive Economic and Trade Agreement (CETA) is fully ratified, municipalities may have a harder time reversing privatization deals once they find out they are not working in the interest of the public. In fact, for the city to reverse a 49 per cent sell-off of control over Toronto Hydro, it could find itself facing lawsuits outside the Canadian court system from foreign investors all too willing to extract more money from the public purse.

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## The impact on consumers

History has shown that turning over public services for private profit frequently costs consumers in the long run. Available evidence indicates that prices for privatized or partially privatized local hydro distributors are higher than publicly owned ones.

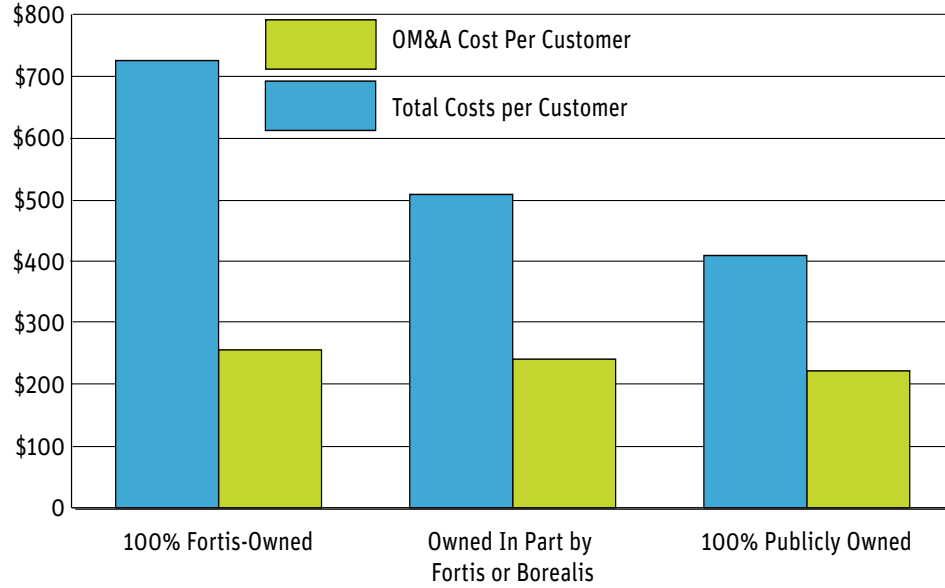
*Figure 2* shows that total costs for fully privatized utilities in Ontario are 77 per cent higher than for fully public utilities; costs for partially privatized utilities are 24 per cent higher than for public utilities.<sup>14</sup> Similarly, operating, maintenance and administration costs are 15 per cent higher for fully privatized local hydro distributors and nine per cent higher for partially privatized ones.

Data show a similar pattern for service reliability between privatized and public local distributors. *Figure 3* shows data on three reliability measures for Ontario local hydro distributors: CAIDI (Customer Average Interruption



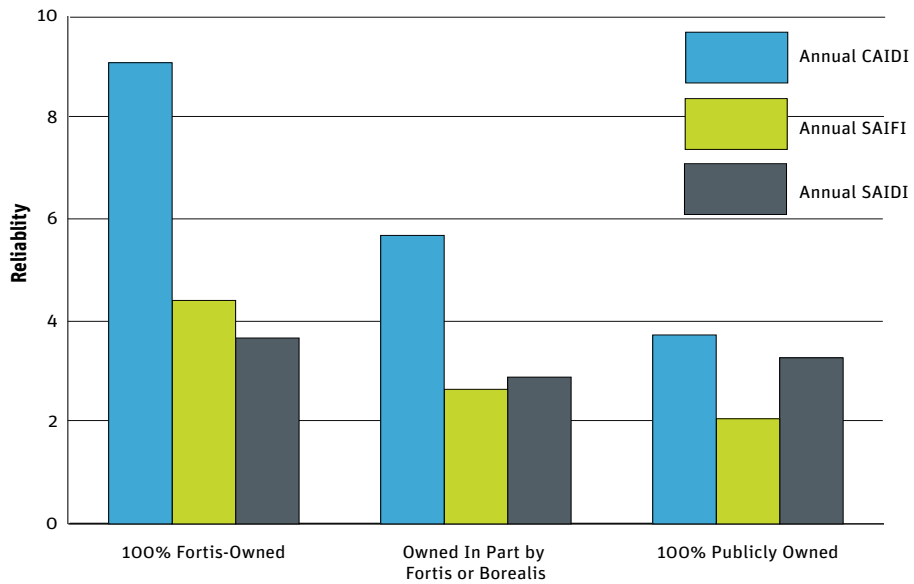
Duration Index), SAIDI (System Average Interruption Duration Index), and SAIFI (System Average Interruption Frequency Index). Almost universally

**FIGURE 2** Privatized LDCs are higher cost producers



Source MPR Associates.

**FIGURE 3** Reliability of electricity supply by form of ownership



Source MPR Associates.

across these measures, public ownership provides for better service reliability than privatized or partially privatized local hydro distributors.

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## The OEB regulatory process is not a panacea

Concerns about escalating costs and limitations on energy conservation efforts are met by privatization proponents with a response that the Ontario Energy Board (OEB) will prevent that. This is a wilfully naïve interpretation of a complex regulatory process.

The OEB is required by statute to allow providers the opportunity to recover their reasonably incurred costs of providing service. That means that the basic building block of the rate setting process is the cost incurred by Toronto Hydro. A recent Mowat Centre report described the limitations of the rate setting process.<sup>15</sup> The first is that significant information asymmetry exists between the applicant and the OEB, as well as any interveners. This means that the regulator knows less than the utility about the information that is needed to set and regulate rates.

The rate setting process provides limited incentives for utilities to control operating, management and administration costs. And there is an incentive to over-invest in assets and capitalize indirect overhead costs, since that is the basis for earnings. While the OEB has a number of strategies to compensate for these limitations in the process, the power of the OEB to effectively regulate and set prices is limited.

These limitations in the process, which are associated with the regulation of a monopoly for an essential service, underline that the regulatory process can have different outcomes. It is widely acknowledged that a privatized utility would have incentives to put more resources into regulatory processes in support of higher prices. That would include hiring more lawyers and consultants and taking a more aggressive stance with the OEB.

Similarly, bromides about the Ontario Energy Board requirements for conservation and demand management are not an adequate response to these concerns about the impact of privatization. The OEB requirements with respect to conservation and demand management are a result of the *Green Energy Act*. It is a piece of legislation that can be repealed. Already, Progressive Conservative leader Patrick Brown has stated that if he forms a government, he will repeal the *Green Energy Act*.<sup>16</sup>

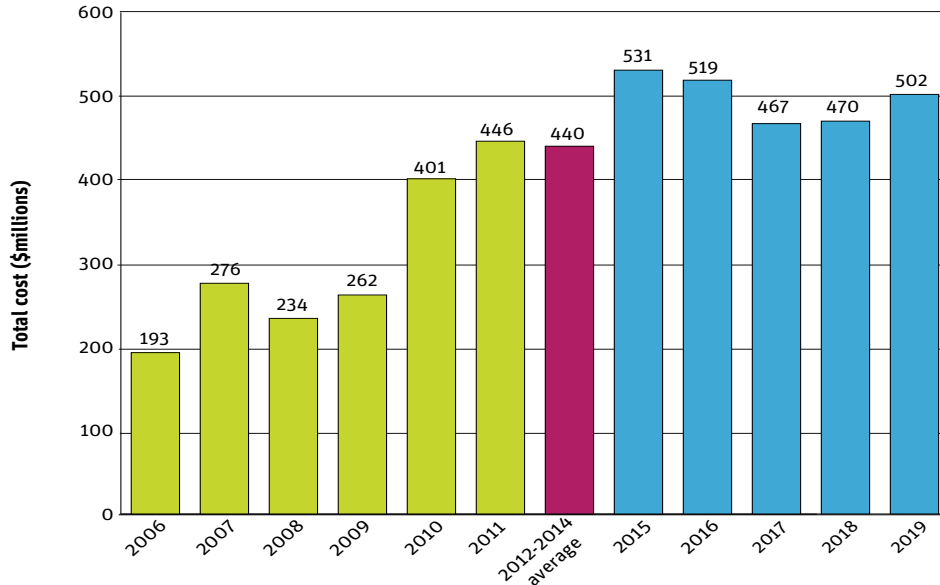
It is important that the city maintain as much policy flexibility as possible in order to continue to be able direct these kinds of efforts.

## Can you spend the same dollars twice?

In his argument for selling off 49 per cent control of Toronto Hydro, the mayor has tried to link power outages with the need for capital investments and privatization.<sup>17</sup> The mayor seems to be saying that we can spend the same dollars twice: once on investments in Toronto Hydro's infrastructure and once on the city's other infrastructure needs, such as transit and housing. It doesn't work that way.

Further, Toronto Hydro's capital plan was approved less than a year ago by the OEB. While the utility proposes a \$2.5 billion investment plan that is described in *Figure 4*, the OEB required Toronto Hydro's plan be reduced by ten per cent over the next five years, resulting in a \$2.25 billion investment. The OEB has approved increases in the Toronto Hydro rates over the five-year period so the resulting costs can be absorbed and a return can be earned on these assets as they are placed into service. This suggests there is no need to privatize to pay for these investments.

**FIGURE 4** Toronto Hydro Capital Expenditure Plan



Source Ontario Energy Board, Decision and Order, EB-2014-0116.

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## Better ways to pay for infrastructure investments

The mayor and city councillors have better options to pay for needed services rather than give up control over Toronto Hydro. Among the options:

- They can raise the city's debt ceiling, which is below the provincial maximum. With the city's yawning infrastructure needs, and historically low interest rates, this is an ideal time to invest by borrowing.
- This city council should take concrete steps to use its power to raise more revenue under the City of Toronto Act.
- The mayor and city councillors could stop starving the city's fiscal coffers by insisting that property tax revenues increase below the rate of inflation.

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## Conclusion

This paper examines the proposal to partially sell off a long-held public asset, Toronto Hydro, in order to pay for city infrastructure needs.

But the facts fail to support the proposition.

Selling off up to 49 per cent of Toronto Hydro would result in the City of Toronto ceding control over electricity prices, hydro service reliability, and environmental stewardship over green energy innovation in the face of catastrophic climate change.

Toronto residents will end up paying the price in the long term: available Ontario data show that partially privatized distributors' costs are 24 per cent higher than publicly owned ones.

What's more, the rationale for selling partial control over this public asset doesn't hold: estimates show a sale of 49 per cent of Toronto Hydro could yield between \$1.5 and \$1.9 billion. At best, this sell-off would provide 6.8 per cent of unfunded capital needs — a drop in the bucket.

In either scenario, city council will have to find a more sustainable source of funding for these projects, as the city's capital funding shortfall would remain above \$27 billion. The city would be wiser to maintain full control over Toronto Hydro and pursue a dual strategy of taking advantage of historically low interest rates through borrowing and addressing its revenue problem on the tax side.

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