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Disastrous electric power privatization

Ontarians will pay a steep price for squandering hydro wealth

By Myron J. Gordon

The privatization and deregulation of Ontario's electric power industry is frightening. It shows ideological blindness, incompetence, or a complete disregard for the interests of the people of Ontario on the part of the Tory government and its business supporters.

Billions of dollars in provincial assets are literally being given away. This will be followed by enormous increases in the price of electricity, and then increases in the taxes needed to pay the interest and principal on the debt originally incurred to pay for the assets.

Apart from the new private owners of the electric power system, no one will benefit from this multi-billion-dollar giveaway. This is clear from looking at the text of the lease of the Bruce nuclear plant to British Energy, and the announcement that Hydro One—the province's transmission and distribution system—is to be privatized through an initial public offering of stock to North American investors.

The question raised by the Bruce lease is not whether the plant should remain in operation or be shut down. The question is whether its huge operating profit of well over $1 billion a year will be used to benefit the citizens of Ontario or flow out of the province and the country.

The Bruce plant has a capacity of 6,784 mw. It is the largest nuclear installation in North America, with a capacity larger than that of Manitoba's entire hydro system. Its potential future operating profit is worth at least $7 billion, and perhaps as much as $10 billion, and it has been given away at practically no cost to a British corporation. The terms of the lease are beyond comprehension.

As for the province's transmission system and much of its distribution system—now called Hydro One—they were built by Ontario Hydro at a cost of over $10 billion. They generated a practically risk-free cash flow (profit net of depreciation but before deducting interest and taxes) of $950 million in 2000 and 2001, and the evidence is that the profits will be substantially larger this year.

Hydro One is worth at least $10 billion under existing rates, and more as its profit margin grows. These assets were written down to $8.6 billion by the government when Hydro One was created, but now Hydro One is to be privatized for $5.5 billion, a little more than half of its true value.

The massive giveaway of the province's electric power system has already raised the provincial debt by $21 billion. Over the next few years it will boost the cost of electricity in Ontario up to the levels that prevail in New York, Michigan, and other parts of the United States. This is a damning indictment of the Tory government—and of the business leaders who support this policy.

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The Energy Competition Act of 1998 authorized the dismemberment of Ontario Hydro (a Crown corporation) into two private corporations—Ontario Power Corporation and Hydro One—that were still owned by the government. The province's $38 billion investment in Ontario Hydro—a magnificent facility with a capacity second only to Hydro Quebec in North America—was written down from the initial $38 billion to $17 billion. The balance of $21 billion was added to the provincial debt, since it would no longer be recoverable through the operation of Ontario Hydro. It is called stranded debt.

The write-down, implemented on April Fool's Day in 1999, was from about $26 billion to $8.5 billion for the entire generating assets assigned to Ontario Power Generation. For the transmission and distribution assets assigned to Hydro One, the write-down was from over $10 billion to $8.6 billion.

The enormous write-down of the generating assets shocked me, so I undertook to evaluate them. I found that a fair estimate of what these generating assets are worth to the people of Ontario under continued Crown ownership is much more than $8.5 billion—even more than their cost of $26 billion. It is $40.7 billion!

How did I arrive at this amazing figure? Here's how: A conservative figure for the value of Niagara Falls and the other hydro assets to the people of Ontario is $16.7 billion. The calculation is very simple. The annual output of the hydro assets fluctuates in a very narrow range: about 36,365 million kwh. With an average delivered price of 7.2c. per kwh, and an average price of 10.2c. in the U.S. states adjoining Ontario, generation is worth at least 4.0c. per kwh. Operating costs are no more than a miniscule 0.32c. per kwh. Combining these figures results in an annual operating income of $1.339 billion. This annual cash flow will be realized as long as the water flows, and it has a present value of $16.7 billion when discounted at an interest rate of 8%. The value rises higher with the price of electricity.

The power generation of Ontario Hydro included 20 nuclear plants with a total capacity of 14,084 mw, over three times that of the hydro plants and more than any other nuclear operation in North America. The value of these assets, however, was open to question, since they had a prior history of mismanagement and the Nuclear Asset Optimization Plan (NAOP), undertaken to restore excellence to their operation, was not certain to succeed. In fact, the NAOP has proven to be very successful—so much so that, with a value of only $3 billion assigned to the fossil fuel plants, the new Ontario Power Generation (OPG) assets are now worth about $41 billion.

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The Electricity Competition Act of 1998 mandated the privatization and deregulation of electricity in Ontario through the divestment of at least 65% of Ontario Hydro's generating capacity. Until that happens, OPG is limited to charging no more than the existing price of electricity, and so the management would not profit from privatization. This legislation pointed a gun at the head of OPG.

The lease of the Bruce nuclear plant to British Energy last year was consummated to realize the divestment objective. It is a "sweetheart" deal if ever there was one. British Energy is better off under the lease than it would be if Bruce had been sold to it for just $1. The lease leaves the responsibility for and the cost of decommissioning the plant with the province. If the plant had been sold instead of leased to British Energy, the company would have had to absorb these costs. As it stands under the lease arrangement, British Energy can just walk away from the plant at any time if it fails to meet the company's profit expectations, leaving the taxpayers of Ontario to shoulder the decommissioning costs.

The profit expectations are enormous. The Bruce nuclear plant has eight reactors. The four reactors in Bruce-B generate 25 million mwh per year. Their annual operation, maintenance and administration cost is about $15 per mwh, and the current regulated price is $38 per mwh. That results in a cash flow (profit before deducting interest and taxes) of $575 million per year for about six years—about $3.5 billion that the government has literally given away.

That cash flow will continue for another 25 to 30 years after a refurbishment that is unlikely to cost more than $2.5 billion. Two of the four reactors in Bruce-A are to be put back in operation soon. The other two require refurbishment before they can be restored to operation, at which time Bruce-A will generate another cash flow of about $575 million a year at current prices, and more as the price of electricity rises.

British Energy and OPG agreed to the lease in principle nearly two years ago—before the California energy crisis. Agreements on the sale of nuclear plants in the U.S. had the prices revised upward by a factor of nine or ten after the California crisis. But the Bruce lease was signed only eight months ago by the Ontario government without any change in its terms. It is a blatant case of "heads British Energy wins, and tails the people of Ontario lose."

The case against privatizing Hydro One is even stronger. Privatization would leave the stranded debt of $21 billion mentioned above unchanged, or even increase it, while continued public ownership of Hydro One would reduce the debt substantially. Specifically, the province hopes to receive $5.5 billion from the sale of Hydro One stock, and another $3 billion from the retirement of Hydro One's debt to the province. In that event, both the province's debt and the province's assets go down by the same amount. If the stock issue is grossly underpriced, as may well happen in order to guarantee its sale, the province's debt will be reduced by more than its assets. By contrast, keeping Hydro One generates $950 million or more year after year towards the retirement of the $21 billion in stranded debt. Why kill the goose that keeps laying the golden eggs?

As large as it is, however, the loss on its sale is not the biggest damage to Ontario as a consequence of the privatization of Hydro One. The biggest loss will be the increased flow of electricity to the United States. With the opening of the market on May 1, the North American Free Trade Agreement (NAFTA) now permits states south of the border to compete for Ontario's electricity—and the only limit on that competition will be the capacity of the transmission lines to move electricity south. Hydro One plans to increase that capacity substantially, and the price Ontarians pay for their electricity will rise correspondingly.

The people of Ontario will pay for the squander of their $38 billion investment in Ontario Hydro in three ways:

First, their taxes will be raised to cover the interest and principal on the $24 billion increase in provincial debt.

Second, the price they pay for electricity will rise to the higher levels now prevalent in New York, Michigan, and other states that will be competing for our electricity.

And third, the profits that Ontario Hydro could have earned with no rise in electricity rates will be lost. It could have been used to support health care, education, and other vital services—as is being done with the profits of the public power utilities in Quebec, Manitoba, and British Columbia. But the profits generated by electricity sales in Ontario will flow out of the country, to foreign investors, further depressing the value of the Canadian dollar.

All of this assumes that the regulations needed to regulate the deregulated industry after May 1 will be efficient and enforced. That, however, is far from a safe assumption. The fiasco in the retail marketing of electricity that Ontarians are now experiencing suggests that the cost will be even higher. Much higher.

Myron J. Gordon is Professor at the University of Toronto's Faculty of Management. He has written over 90 books and articles on economics and finance. He is past president of the American Finance Association, and Fellow of the Royal Society of Canada. He is considered one of the country's leading experts on the generation, distribution and sale of electricity.

An electronic version of this piece is available from the CCPA webpage at: www.policyalternatives.ca
For more information or to arrange an interview contact Kerri-Anne Finn at the Canadian Centre for Policy Alternatives, Tel: (613) 563-1341 ext. 306

Canadian Centre for Policy Alternatives — National office
410-75 Albert Street, Ottawa, ON K1P 5E7
Tel (613) 563-1341 Fax (613) 233-1458
e-mail ccpa@policyalternatives.ca
www.policyalternatives.ca