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There Is No Case for Privatizing Hydro One

A critical assessment of the "business case" for abandoning public ownership and control of Ontario's most strategic asset

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Some things about Hydro One are not in dispute: for example, the fact that it manages North America's second largest transmission and distribution network, and manages it well. Everyone also agrees that Ontario's highly reliable electricity networks have been crucial to the success of its economy and to the well-being of its residents.

But the government now insists that, after almost a century of public ownership, it is time to sell the province's transmission and distribution systems to private and foreign investors. We believe quite firmly that it is not. Indeed, by any objective measure, abandoning public control of this vital public infrastructure simply makes no sense.

When a judge of Ontario Superior Court ordered a halt to what would have been the largest privatization in Canadian history, the provincial government was offered an important opportunity to give this initiative sober second thought. Since that moment, a lot has been written and said about the wisdom, or lack thereof, of privatizing this essential public infrastructure. Unfortunately, much of this commentary is misleading and inaccurate.

Given the enormous public importance of the decision this government seems poised to make, we believe there is a need for more light, and less smoke, when it comes to understanding the pros and cons of privatizing Hydro One.

As concerned and knowledgeable observers, we thought we could offer a little insight into one aspect of this debate that many may find confusing. We are referring to the business case the Minister and Premier have offered for privatizing Hydro One. We thought it would be helpful to assess the merits of their argument by comparing two scenarios: one where Hydro One is privatized, the other where it remains in the public sector.

Ownership and Control

Public ownership means that Ontario citizens own Hydro One through the provincial government. The government exercises public control by appointing its board, and giving it direction. It means that Hydro One's priorities stay firmly fixed on meeting the needs of Ontario, not those of private investors and foreign consumers.

The strategic priorities of a privatized Hydro One would be set by the board of directors to maximize shareholder value. If the Initial Public Offering (IPO) of Hydro One shares had succeeded, Hydro One's current management intended to aggressively expand into U.S. markets. It estimates that it would need billions of dollars to do so. According to this ambition, Hydro One would become a transnational corporation with significant foreign ownership, and a strategic focus on serving North American not Ontario markets. This is precisely the strategy that has led many more experienced private sector corporations in the telecommunications sector into financial disaster—Teleglobe, which once was a Crown corporation, being only the most recent casualty.

Equally troubling, the IPO would have imposed no constraints on foreign ownership. The government claims that, once privatized, free trade rules won't allow such limits. While the government planned to limit ownership by any one investor to 15% of Hydro One shares, there would be no statutory or other guarantee that this limit would be maintained. We believe that, if privatized, there is a very real risk that Hydro One will ultimately be controlled by a U.S.-based energy giant.

Paying Off Ontario Hydro's "Stranded" Debt

The province has said that it would use the net proceeds of the sale of its shares in Hydro One to pay down something it calls the "stranded debt." The figure of $38 billion is often mentioned. The debt problem, and the proposed solution to it, are both red herrings. In fact, the government created the debt problem it now claims to be solving when it liquidated Ontario Hydro. In its place it established a maze of corporations, among them Hydro One and Ontario Power Generation (OPG). In the process, the government wrote down the value of Ontario Hydro's assets from $38 billion to $17 billion. That left $21 billion in debt uncovered by assets. It is this figure, not the 38$ billion, that everyone from the Minister to Maurice Strong likes to cite, that is called the "stranded debt."

Look now at the sale of Hydro One through an Initial Public Offering (IPO) of its shares. The IPO does little or nothing to solve the stranded debt problem. The sale would at most realize $5.5 billion, but that would contribute only $1.5 billion towards paying down the stranded debt, since the shares are on the government's books at $4 billion. However, the investment bankers are silent on the price they will actually pay for Hydro One shares. In fact, they are now only committed to take the shares on consignment—that is, buy only the number of shares they can sell to the public. In fact, the IPO may be sold for considerably less than $5.5 billion, contributing little, if any net proceeds towards the stranded debt. Moreover, a partial sale of the IPO would have serious tax consequences for the province.

Even more to the point, continued public ownership represents a much better deal than selling the goose that lays the golden eggs. Last year Hydro One generated $641 million in profit after paying interest on its debt, but before payments in lieu of taxes. This is a 16% return on the $4 billion investment in continued public ownership. Not only can this revenue be used by the Ontario government to pay down Ontario Hydro's (not Hydro One's) stranded debt, but it can also be used for years to come to pay for health care, education, or for any other public purpose. In fact, this was precisely what the government claimed it would do when it introduced the legislation that created Hydro One. The bottom line is that continued public ownership of Hydro One is virtually risk-free, since we both own and consume its output.

Access to Additional Capital

First the smoke: the government has claimed repeatedly that the transmission system is run down, and that the IPO is needed to raise the capital to rebuild it. In fact, the Hydro One IPO would not contribute one single penny for investment in either maintaining or upgrading its transmission system. The preliminary prospectus it filed makes this quite clear. The proceeds of the IPO would go to pay down the non-stranded debt and result in privatizing Hydro One's income.

The truth is that, as a Crown corporation or a private company, Hydro One would be able to raise needed funds from cash flow and from capital markets. Indeed, as a Crown corporation, it would be able to raise funds at a lower interest rate than would a private corporation. The claim that there is a pressing need for funds to upgrade Hydro One's system is contradicted by its own actions. Why has not the present management used its funds for that purpose, instead of going on a $550 million spree of buying municipal distribution systems? The question has only two possible answers. Either the management believes that expanding its empire is more important than maintaining its system, or the need to upgrade the transmission system isn't so pressing after all. Which is it?

Even more problematic are Hydro One's plans to raise capital to invest in expanding its system into the U.S. This raises the prospect of Ontario consumers paying for this corporate adventurism. Who do you think will pick up the tab if its ambitions fail, as have those of many more experienced corporations?

The False Promise of Private Sector Efficiency

The Premier has repeatedly claimed that there is a pressing need to introduce private sector "discipline" to the management of Hydro One. At a time when the business pages are full of accounts of corporate failures of unprecedented scale, we wonder what discipline he is referring to. Many of these recent meltdowns, of course, occurred in the telecom sector—until recently a poster-child for those promoting the privatization of Hydro One.

The fact is that a privatized Hydro One would have to increase efficiency dramatically to achieve the same level of profitability at which Hydro One now operates. The cost of capital is simply more expensive to a privatized Hydro One. This means having to pay more, not less money for the same service. More worrying is the real danger that, to generate better returns for shareholders, a privatized Hydro One might cut spending on staff or maintenance. We cannot afford a management that plays with a system upon which every person and every business in this province depends.

The government says, not to worry, the Ontario Energy Board will ensure that the performance of Hydro One will be maintained. But the complex tasks of ensuring proper system maintenance and a fair profit rate are well beyond any challenge the OEB has ever had to meet. It does not have anything like the resources and expertise needed to assume the role of a hands-on regulatory agency, capable of actually monitoring Hydro One's operations in the field. Moreover, the indifferent job it has done at the far simpler task of regulating retail electricity marketers hardly inspires confidence. Given the spectacular failure of regulators in California and elsewhere, it is difficult to be sanguine about the effectiveness of OEB oversight.

Who Benefits

In addition to the substantial fees that will be paid to its underwriters, and the compensation packages bestowed on Hydro One's management, the real beneficiaries will be the private and foreign investors who acquire Hydro One shares. Even at $5.5 billion, the IPO would raise much less than its fair value under continued provincial ownership. That is at least $9 billion. The pattern of undervaluing public assets when they are privatized is unfortunately well established. This is obviously a great deal for private investors, but a terrible deal for Hydro One's current owners, the people of Ontario.

Selling Hydro One shares at a deep discount will also set the stage for a foreign takeover by a U.S. multinational corporation willing to pay much closer to fair value for control of such strategic assets. Once privatized, NAFTA rules prohibiting discrimination against foreign investment, together with the interests of influential private investors anxious to sell their shares at a substantial premium, are likely to overwhelm any public outcry against such a takeover.

The other beneficiaries of privatization will be U.S. consumers, who will, under NAFTA, be guaranteed continued access to Ontario electricity even if domestic shortages occur. Under NAFTA, the OEB can't restrict exports or charge U.S. customers more for power than is charged the people and businesses of Ontario. Free trade rules are now kept at bay by two factors: limited transmission capacity to the U.S., and provincial ownership. Privatizing Hydro One will quickly remove both of these protective barriers. For Ontario residents and industry, this will mean both increased prices and diminished energy security.

On the other hand, the beneficiaries of publicly-owned Hydro One are clearly the people and businesses of the province. Among the many benefits of public ownership, perhaps the most important is the security that comes from controlling a power system that is absolutely vital to the well-being of every resident of the province. No foreign take-overs, no risk of market manipulation to increase profits, no exposure to foreign investor claims or trade challenges, no obligation to provide U.S. consumers access to Ontario energy on precisely the same terms it is supplied to the residents and businesses of this province.

The people of Ontario built Hydro One. They are entitled to benefit from the fruits of their labour.

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