2017/18 & 2018/19 Manitoba Hydro General Rate Application
February 1, 2018

Presentation by Murray Taylor on behalf of the Business Council of Manitoba

Good Afternoon.

I am here to represent the Business Council of Manitoba. Our mandate includes researching and advocating innovative positions on selected issues that bear directly on the future health of Manitoba society without regard to partisan politics.

Professionally, I studied to become an actuary and then worked for Great-West Life and Investors Group for 40 years retiring as CEO of Investors Group in 2016.

I have been a member of the Business Council for many years and have held various Board and Committee positions. Since 2012, I have chaired our Fiscal Issues Committee, which provides annual pre-budget advice to our Minister of Finance. For the last three years we have identified the growing level of debt, related credit rating concerns and interest cost implications on Manitoba Hydro and the Government of Manitoba in obtaining and servicing this debt. (See Appendix A for excerpts)

We are very concerned with the current and future financial condition of Manitoba Hydro. Manitobans will be burdened with much higher hydro rates and taxes in the future in the absence of significant increases in hydro rates over the next few years, and especially over the two years under consideration in this rate application.

Our concerns relate to:

1) Current Net Debt levels of $15.4 Billion[1] growing each year to at least $23.3 Billion[2] by 2021 as more funds are borrowed to complete Bipole III (totalling $5 billion) and Keeysak (totalling at least $8.7 billion). Higher actual project costs would lead to even higher required debt levels.

2) Interest costs on the construction debt are currently being capitalized in the project costs until completion, which masks these debt costs being incurred for your rate setting period that is currently under consideration.

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[1] Appendix 3.8 - MH16 update with interim.
[2] Appendix 3.8 - MH16 update with interim.

3) Manitoba Hydro needed to borrow over $200 million in each of 2016 and 2017 just to pay operating costs as rates were not sufficient and they are projecting to need to borrow over $800 million from 2018 to 2024 if rate increases are limited to 3.95%[3]

4) The total annual interest and depreciation charged in Manitoba Hydro expenses are currently $969 million [4](finance expense of $573 million and depreciation of $396 million) for 2018 which will grow substantially to be $2.027 billion[5] (finance expense of $1.312 billion and depreciation of $714 million) by 2024 – more than doubling in only 6 years based on the current financial forecasts.

5) Holding rates below the costs of running Manitoba Hydro seems strange when we have amongst the lowest cost for electricity of any location in Canada and the United States. To the west, Regina has residential hydro rates 77%[6] higher than Winnipeg and using Ottawa for an Ontario proxy, our neighbours to the east are 47%[7] higher than Winnipeg.

6) Forecasted net income levels are likely optimistic. We have had no drought scenario in the last 14 years, the demand and price of our energy is under pressure in the export markets, current mega-projects may well cost more than projected, and the sheer required volume of debt will see interest costs escalate beyond expectations if interest rates rise and/or credit spreads widen for Manitoba long term debt.

    a) Interest rates are at record low levels and we have been lulled into believing this may last indefinitely which can change quickly and surprise everyone. As Manitoba Hydro borrows for increases in debt levels and refinances existing debt on its maturity dates, the potential for higher interest costs is the most likely scenario given the long low levels recently experienced.

    b) The economy is currently quite strong in Manitoba, Canada and globally, which gives everyone a false security in how credit markets react. But if the economy starts to struggle as it does periodically, access to issuing debt will become more limited and, interest rates on lower rated debt will undoubtedly increase.

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[3] MH-52 – MB Hydro Rebuttal Evidence, Figure 1.10.
[4] MH-64 – slide 17.
[5] MH-64 – slide 17.
[6] MH-64 – slide 12.
[7] MH-64 – slide 12.

c) It is not unlikely that excessive debt in Manitoba, arising in large measure from Manitoba Hydro, which will soon be 50% of total Government of Manitoba debt, combined with unfavourable economic environments could lead to increases in credit spreads of up to .50% on top of potentially higher interest rates in general of 1% or more. The exposure to such increases at a time of rapidly growing debt poses a significant risk, which if realized, will result in huge costs for Manitoba Hydro customers and the Province of Manitoba in the future.

d) If Manitoba Hydro was exposed to a 1.5% higher interest rate on their estimated $23.3 Billion debt in 2021 they would be incurring an additional annual interest cost of $350 million. For perspective, the difference between the annual impact of a 7.9% rate increase next year versus a 3.95% increase is only about $70 million of incremental income.

e) The credit rating agencies have become much more rigorous since the financial crisis 10 years ago and will continue to tighten their analysis of each entity they examine. They have identified rate increases as a distinct opportunity for Manitoba Hydro to maintain financial responsibility – it will be important to signal to the credit rating agencies and the bond investors they serve that we will use this tool of rate adjustment responsibly when it is needed such as now! Showing leadership with substantial rate increases for the next 2 years will be important.

In my experience as a public company corporate leader, I can say the best time to acquire good terms and rates for debt is when you can prove you do not need the debt.

When your financial affairs are built on needing significant levels of increasing debt, the terms and costs get very unattractive. If this happens at the same time that the local or global financial outlook is distressed, it becomes very expensive or potentially unmanageable.

Less than a decade ago, in 2008, I watched as we went several weeks and months with virtually no bond issue being funded into the market other than federal government debt advanced to add liquidity in the markets. When the markets turn it often happens quickly and more severely than imagined.

On reflection, our Manitoba Hydro rates could have been increased gradually and we would still be substantially cheaper for retail hydro rates compared to our neighbours.

Such actions would have put Manitoba Hydro on a stronger economic footing to help absorb the huge costs of building and financing Bipole III, which creates no revenue, and Keeyask, which has limited revenue compared to the cost of building this dam.

We did not increase these rates because technically Manitoba Hydro has no "actual expense" for their multi-billion dollar projects until they are completed. Pinning our rate setting to this accounting rule that defers reality is hardly wise stewardship.

It is like telling your kids to ignore $100,000 of student debt while they are studying to gain their credentials as it is not really an expense until they graduate – what parent would give such advice? – rather most of us would encourage our kids to work all summer and take on part time jobs to limit the amount of debt cost they must bear in future years.

But unfortunately this was not the case for Manitoba Hydro, and we are faced with the need for more substantial increases now. Any delay, in making these increases, will inevitably lead to much higher increases in the future as we will be forced to acquire higher levels of debt at inopportune times.

We appeal to the Public Utilities Board to consider a path to ensuring financial stability and the lowest costs over future years collectively, which in our view is well represented by the proposal made by Manitoba Hydro.

Thank you for the opportunity to share these thoughts with you today and we trust they will be helpful as you deliberate and come to very important conclusions for Manitoba Hydro rates over the next 2 years.

Appendix A

Excerpts from budget submissions from the Business Council of Manitoba to Manitoba's Finance Ministers in 2017, 2016, 2015 relating to Manitoba Hydro

2017 Budget Submission – to Finance Minister Cameron Friesen on March 6th, 2017

Fiscal Management
After years of repeated deficits Manitoba is confronted with a serious fiscal situation. Deficit years outnumbered years with a surplus over the past thirteen years.

Debt has continued to grow. Annual interest payments on the debt weigh heavily on the government and Manitoba taxpayers. Borrowing to pay interest costs further impairs government's capacity to provide services for Manitobans to the point where the obligation to pay the interest on the public debt is the greatest threat to continued services.

Accumulated net debt has doubled since 2007-2008, standing at $21.4 billion at the end of the 2015-2016 fiscal year. Annual interest payments remained relatively constant, but only because interest rates fell over much of that period. For example, the Bank of Canada Rate was 1.75 percent in December 2008 compared to 0.75 percent in December 2016. Manitoba cannot rely on fortuitous interest rates into the future. When rates in the U.S. begin to move they will affect international borrowings.

Continuing deficits require more borrowing, increasing the debt, and in turn interest charges. The fiscal pressure on the province mounts.

The current debt amassed over several decades and eliminating the deficit created by the debt load is not a short-term task either. In its first budget the government realized the enormity of the challenge when it committed to an eight-year timeframe for producing a balanced budget. We recognize the difficulty of overcoming a deficit as large as the one confronting the Province of Manitoba. Last year the deficit was attributable to interest payments exceeding $800 million. Prolonged action will be necessary.

When we met your predecessor more than a year ago we spoke of the challenges in managing the debt and protecting the credit rating of the Province of Manitoba; we expressed concern that the growing debt at Manitoba Hydro, which if added to the Manitoba Government debt, would severely impair credit ratings leading to potential higher servicing costs for Hydro and the Government of Manitoba, and in the extreme, to limited access to debt markets. Although rating agencies have historically looked at Hydro and Government debt separately, they are increasingly commenting on Hydro debt and it is not a big stretch to think they might start combining them given that the Province of Manitoba guarantees the debt of Manitoba Hydro.

We encourage the government to take the steps necessary to ensure that Hydro can be placed on a solid independent financial footing, thus restoring the utility to a dividend-generating asset for all Manitobans, while at the same time safeguarding the province's overall financial stability. The steps need include a concerted effort to convince the rating agencies and the bond market participants that Hydro should continue to be considered a separate entity and not rolled up into the Manitoba Government total debt for their evaluations. Proper capitalization of Hydro and an indication that rate increases of some measure to sustain the Hydro debt are viable over coming years would help to stave off concerns that may emerge surrounding the credit ratings. We consider action on this item to be of the highest priority.

Also with respect to Manitoba Hydro, we continue to recommend that the government actively pursue discussions with neighbouring provinces and the federal government on establishing a Canadian national power grid to provide more capacity for diversity exchange and power sharing, access to larger markets, and increased security of supply. Such a grid may provide additional markets and revenue for Hydro. A national electricity grid based substantially on hydro electric generated power will contribute to achieving Canada's target for greenhouse gas emissions.

While there are serious taxation issues to be addressed to enhance the competitiveness of our businesses and our economy revenues from all sources are not sufficient to meet our $800 million obligation for interest payments. The reality is that this year the government is not in a position to consider significant tax relief for Manitobans despite a strong wish to do so. However, we continue to advocate for a full review of the provincial taxation structure to ensure competitiveness while government receives the revenue it requires to fund services. The Business Council is prepared to participate in a comprehensive review.

We recommend the province continue to practice prudent expenditure management, and also adopt measures to grow the economy which includes continued critical investments in infrastructure and capital projects.

2016 Budget Submission – to Finance Minister Greg Dewar on November 26th, 2015

Stable Fiscal Framework

A sound, stable fiscal framework is the starting point for a prosperous growing economy. We believe it is important to aggressively pursue a balanced budget over the next several years through efficient and prudent government operations. Continual deficits will place us in an increasingly precarious position when interest rates begin any upward movement. Even with the current extremely low historic interest rates annual debt servicing costs remain over $800 million per year. Net debt has been rising since 2007/2008.

Although low for a lengthy period of time, interest rates will eventually rise, and that in combination with the higher debt level will place fiscal pressures on the province. Forecasters are warning rates may begin to rise in the next two quarters.

A very simplistic analysis demonstrates the significance of higher interest rates. If rates increase by only 1 per cent with the current total gross government borrowings of $36.2 billion, the result would eventually be an additional expenditure of $362 million (1% x $36.246 billion). To put this in another perspective the increase in interest costs would account for an additional 2.4 per cent of the total summary expenditures for the provincial government in 2014/15. A larger interest rate hike would have a bigger impact.

The actual net increase in expenditures would be lower as interest rates for existing debt issues are locked in, and in fact some investments held by the provincial government would benefit from the higher interest rates partially offsetting higher debt servicing costs. Nevertheless, it is readily apparent that any increase to interest rates will over time place a significant added burden on the fiscal position of the province and either reduce the government's ability to fund programs, require the government to increase revenues (e.g. increase taxes), or result in a higher deficit.

Moody's Investors Service dropped the Government of Manitoba's long-term credit rating in July 2015 to Aa2 from Aa1 citing a fast-growing debt load and a failure to meet balanced budget targets. The first Moody's downgrade for Manitoba in more than two decades is seen as a significant signal that Manitoba's finances are deteriorating.

When compared to the three other western provinces, Manitoba's credit rating is lower than all of them. When compared to eastern and maritime provinces Manitoba's rating is similar or in some cases higher.

In our view Manitoba cannot afford to risk further rating reductions. The impact on budgets for health, education, government services and critical infrastructure would be severe.

Complicating the challenge of debt management and protecting our current credit rating is the large and ongoing demand for capital from Manitoba Hydro. That demand will continue for several years, making it all the more imperative that sound commercially viable business decisions be made by Manitoba Hydro, consistent with Public Utility Board decisions and directives.

Our hydro resource has a role to play in overall energy security and dependability in Manitoba and more broadly in the west and nationally. Development of the resource however should be consistent with customer demand and our capacity to construct new generation facilities and transmission lines cost effectively.

We appreciate that other factors affect debt management and reducing annual deficits; in particular the value of the Canadian dollar and oil prices, revenue generation from the tax system, and interest rates. However, it is imperative that progress be achieved sooner not later.

2015 Budget Submission – to Finance Minister Greg Dewar on February 5th, 2015

Energy

1. The economic, financial and environmental conditions affecting Manitoba Hydro's ability to competitively negotiate and sell power internationally are in a state of flux. The Government of Manitoba should be mindful of the potential financial impact on domestic ratepayers who will ultimately pay for miscalculations. The government's decisions should be based on the best analysis available to safeguard the province's future financial stability.

2. The government should actively pursue discussions with Ontario and its western neighbours on establishing a domestic national power grid to provide for larger and more accessible markets, increased opportunities for diversity and power sharing, and increased security.

3. The government must ensure its energy policy reflect the volatility in international energy markets, particularly the dramatic fluctuations in the price of oil, and the significant emerging technological changes in non carbon-based energy sources, including solar, and battery storage.

4. The government should continue to cooperate with other Canadian jurisdictions in developing a pan-Canadian energy strategy leading to development of our mixed energy sources, enhanced interconnections leading to improved long-term energy security, development of alternative energy sources leading to reduced GHG emissions, and improved capacity to export surplus supplies. A Canadian strategy is essential if Canada is to benefit in the long term.