Fedeli **Focus on Finance**

Financial House of Cards

Volume 4: No. 7 | July, 2017

Ontario

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Financial House of Cards

There were two separate issues that either reflected or affected the state of Ontario's finances this month. The first featured a large and varied group of analysts who independently outlined the true state of Ontario's economy, and the reasons behind it. The second was Hydro One's announcement of their planned purchase of U.S. utility Avista. I'll break these down and present the numbers you need to know.

Economic Recovery?

Each quarter, the Conference Board of Canada publishes their *Provincial Outlook Economic Forecast*, providing their short-term outlook for Canada's provinces. While they forecast a number of provinces will perform better in 2017, Ontario and B.C., which led the provinces in growth for 2016, will see slower economic growth. This was backed up by several other analyses published over the month.

Phillip Cross authored *Ontario's One Cylinder Economy*, focusing on housing in Toronto and Ontario's weak business investment. He illustrated the province's increasing dependence on Toronto's housing market for growth, leaving it especially vulnerable if the market slows. The Financial Accountability Officer outlined the same concern in his *Spring Economic and Fiscal Outlook*. He stated "The relative importance of residential housing investment to the overall economy has increased substantially in recent years, posing a significant risk to the Ontario economy, in the event of a sharp housing market correction." The FAO also pointed out that residential housing accounted for a record 8.3% of Ontario's nominal GDP and that back in 1989 it hit 8.2% before tumbling to just over 5% in 1991 and falling to less than 4% by 1996.

CFIB Survey Results (more than 3,500 member responses)	
Which of the following actions would your business take as a result of (the proposed) minimum wage increases?	
Increase prices	66%
Reduce hiring	64%
Less employee hours	53%
Cut employees	43%
Consider closing, or moving out of Ontario	34%

Cross' paper also identified several factors that are currently at play in Ontario, discouraging business investment. Ontario has amongst the highest all-in electricity costs in all of North America. According to the Auditor General, provincial government policy decisions increased hydro costs by $37 billion between 2006-14. Outside of Atlantic Canada, Ontario has the highest labour costs, and minimum wage is poised to increase to $14/hr this January, and $15/hr by 2019. And in addition to many regulatory burdens, Ontario has the 2nd highest marginal personal tax rate in North America, at 53.5 %. As a result of the high cost of doing business, manufacturing sales are little changed since 2003, compared with gains of 14% in Quebec and more than 20% in B.C. and Alberta. Manufacturing investment has been halved since before the recession in industries such as computers and electronics, lumber, paper, printing, rubber, and plastics. Overall business investment has actually fallen from $53.8 billion in 2008 down to $50.9 billion this year.

The Canadian Federation of Independent Business' *Business Barometer Index* showed Ontario took a nosedive, dropping 10 points to 58, the largest month-to-month drop in its history. They claim the tumble is policy-based, referring to sweeping labour standards legislation, which appears to be adding considerable uncertainty over future operating conditions in Ontario.

According to fDi Intelligence, Ontario is now the #3 destination for foreign direct investment, with $4.5 billion. They inched ahead of Texas, which slipped from 2nd to 4th place, at $4.4 billion. In both 2014 and 2015, Ontario was ranked #1, receiving US $7.1 billion in foreign capital.

S&P Global raised Quebec's credit rating from A+ to AA-, meaning that for the first time ever, Quebec's credit rating ranks higher than Ontario's. The agency stated that over the next couple of years it expects Quebec to keep its budget in the black and its debt ratios in decline thanks to strict cost controls, growing tax revenues, and prudent fiscal policies. This has boosted the confidence of businesses considering Quebec as a destination for investment. At the same time, S&P lowered Ontario's short-term rating to A1 from A1+, leading to the concern that business will have to shoulder any increased costs, adding a further chill to the Ontario investment climate.

Finally, the Fraser Institute's Ben Eisen weighed in with various commentaries on Ontario's 'recovery'.

"From 2003-14, inflation-adjusted economic growth per person in Ontario averaged 0.3% annually – a third of the national average. From 2004-14, annual private-sector job growth in Ontario averaged 0.6% – approximately half the rate of job creation in the rest of Canada. As a result, average incomes in Ontario fell relative to the rest of the country. In 2012, average disposable household income in Ontario fell below the national average for the first time." His releases prompted back-and-forth letters between the Finance Minister and Eisen – and I couldn't help but weigh-in with my own editorials outlining further supporting facts about the real state of Ontario's economy. All of these revelations led to this month's title – Financial House of Cards!

The Hydro One/Avista Deal

Hydro One announced a deal to acquire Avista Corporation for $6.7 billion, in an all-cash transaction. The deal is expected to close in the second half of 2018, and is still subject to approval from common shareholders and various regulators. Avista shareholders will receive US$53 in cash per common share; a 24% premium over the market close on the day of the announcement. Moody's and S&P reacted swiftly by changing Hydro One Inc.'s credit outlook from stable to negative. Recall that following the sale of Hydro One shares, their credit rating was downgraded twice in two months, from A1 to its current A3. Avista provides natural gas and electric service to about 350,000 homes and businesses across Washington, Idaho, Oregon, and Alaska. Hydro One services 1.3 million customers.

The deal is not without several controversies. It puts Ontario back in the "dirty coal" business, as the government so fondly described the industry in the past. Avista owns a 15% stake in two units of the Colstrip coal plant in Montana; the second-largest coal-fired plant west of the Mississippi. It is one of the U.S.'s top 20 greenhouse gas-producing plants and responsible for an 800-acre coal ash waste pond. In addition to the optics of supporting "dirty coal", there's the reality of the estimated $1 billion clean-up of the pond. Avista's share could top $100 million, and the concern is that Hydro One ratepayers may be on the hook. This took on a new level of concern when Avista CEO Scott Morris stated the sale means "we can spread out costs over a larger customer base."

Premier Kathleen Wynne stated she discussed the coal business with Hydro One's Mayo Schmidt in which she expressed her hope that Ontario's coal-free "value system" would be shared. "We want that to happen all over the world", she added. However U.S. media reports claim there will be no changes in Avista's power generation.

Hydro News Keeps Coming

News of skyrocketing hydro costs kept coming all month. The Ontario Society of Professional Engineers (OSPE) reported that in 2016, the province wasted a total of 7.6 terawatt-hours of clean energy – an amount equal to powering more than 760,000 home for a year, or $1 billion. That's a 58% increase over the amount wasted in 2015. All this happening "while the province continues to export more than 2 million homes-worth of electricity to neighbouring jurisdictions for a price less than what it cost to produce," said Paul Acchione, former President and Chair of OSPE.

The $1 billion loss happens when power is not needed in Ontario, and could not be exported, so it is simply dumped. "It's when we tell our dams to let water spill over top, our nuclear generators to release their steam, and our wind turbines not to turn, even when it's windy," said Acchione. In addition, power was exported from 2014-16 at prices much lower than the total cost of production because Ontario produces far more electricity than it can use, so it is forced to sell this surplus power at a loss. "Taken together, those represent nearly enough electricity to power every home in Ontario for an entire year," said Acchione.

This was followed up with a shocking report from the Fraser Institute, *Evaluating Electricity Price Growth in Ontario*, revealing that Ontario has the fastest-rising hydro prices in the country – and poor policy is to blame. As for the so-called Fair Hydro Plan, which went into effect in July, the "government has just covered up serious problems in the system by shifting the cost onto taxpayers and future hydro bills," stated co-author Kenneth Green. "What hasn't changed are the government-driven decisions to favour costly wind and solar power purchased at above-market prices," he added.

"These political decisions are the reason Ontario electricity prices soared by 71% between 2008-17, while the average growth across the country was 34%," said Green. Last year alone, Ontario realized a 15% increase in prices, over the previous year. As a result, July also saw several Ontario facilities either close or move due to skyrocketing hydro rates. Paul From, President of Central Wire Industries, announced their plant in Erin will cease operations, sending 26 workers home. He directly attributed the decision to the high cost of electricity.

Conclusion

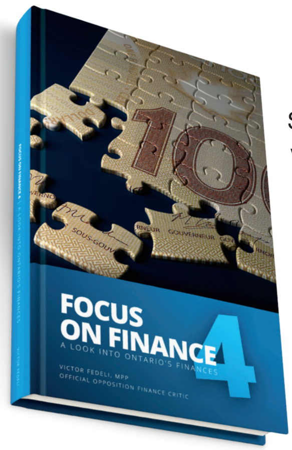
July offered a harsh reality, with so many groups weighing-in on the true state of Ontario's economy and finances. From concerns over the dependence on Toronto's housing market, the factors creating a discouraging business climate, falling foreign capital investments, and the anemic private-sector job growth, there is certainly evidence that Ontario cannot continue in its current direction.

Key Questions

When will the Premier and the Finance Minister come clean with the people of Ontario and present the true state of Ontario's economy?

Why does it always take the Auditor General, the Financial Accountability Officer, or the OPP to get the true story?

Will the Minister of Energy halt the rate increases sought by Hydro One, seeing as they appear to have excess cash to purchase a foreign-owned utility?



Similar stories of waste, mismanagement, and scandal are disclosed in my new book, ***Focus on Finance 4***.

Please go to **www.fedeli.com** to download your own copy of the book.

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