Intelligence MEMOS

From: Glen Hodgson

To: Overseers of Crown Corporations

Date: July 8, 2021

Re: **How is Hydro One Performing on Crown Governance?**

Canada's Crown corporations form a major part of the economy, but rarely draw detailed scrutiny. In his latest C.D. Howe Institute Commentary and in this special Intelligence Memo series, Fellow-in-Residence Glen Hodgson assesses governance at Hydro One, a publicly traded company with significant ownership by the Province of Ontario.

Hydro One is Ontario's largest electricity transmission and distribution provider. It had 2020 revenues of about $7.3 billion, and held $30.3 billion in assets at year-end. Its transmission business is essentially a natural monopoly accounting for approximately 98 percent of Ontario's transmission capacity. To protect the public interest, a natural monopoly is usually managed via either public ownership, or public regulation of a private company. Aside from its governance practices, Hydro One is closely regulated through the Ontario Energy Board.

In 2015, the previous Ontario government decided to partly privatize Hydro One, a decision that was politically contentious. The stated rationale was to strengthen the company's long-term performance and generate value for Ontarians by broadening ownership. Shares were sold off in three stages from 2015 to 2017, raising roughly $6.3 billion. The province retained 47.4 percent via direct ownership, plus 1.5 percent via Ontario Power Generation (OPG).

My recent C.D. Howe Institute Commentary highlighted the particular attention to governance required for a corporation jointly owned by government and private shareholders. Detailed advance definition of the limits of government influence over the corporation is arguably the most effective way to achieve policy goals, and avoid uncertainty and possible disagreements.

Early into the transition, Hydro One's board took important steps to develop a clear governance framework, and produced a governance agreement in November 2015.

It committed to best practices in corporate governance policies, procedures and practices, while recognizing the province as a large shareholder. It also defined the board's role and its oversight of the CEO and management team, including a requirement for the CEO's annual renewal. The province was to engage in the business and affairs of Hydro One and the Hydro One Entities as an investor and not as a manager. This agreement, *de jure*, seemed an important step in good corporate governance for the partly privatized firm.

Nonetheless, CEO compensation and the role of the board became a prominent issue during 2018 provincial election. And afterwards, despite its minority stake, the new government behaved as if it has a "golden share." Thus, the *de jure* governance agreement was crowded out by *de facto* political intervention. The CEO departed and the board resigned, en masse.

Politicization of the governance process at Hydro One came with consequences. Notably and shortly thereafter, state energy regulators in the United States rejected Hydro One's proposed $6.7 billion takeover of Avista Corp, on the basis that "political considerations" in Ontario would affect customers in the western US. Hydro One's ability to grow as a business through acquisition was thus immediately hurt.

Since then, Hydro One and its new board and CEO have had to work hard to try to re-establish public and investor confidence in its governance practices. The firm has emphasized the importance of corporate governance in effective management, highlighting independence, integrity and accountability as the foundation of its approach to good governance. Private sector discipline in cost containment has yielded significant business outcomes and allowing Hydro One to grow its dividend marginally.

The Hydro One website contains useful recent documentation that provides clarity on the board's mandate, on governance practices and the board's role in decision-making on the CEO, and on CEO and executive compensation. These are necessary and important steps to rebuild confidence; whether they are sufficient is still an open question. Similarly, the Chairman's statement in the 2019 Annual report emphasized that "Hydro One has an incredibly important mandate in serving the people of our province and in delivering outstanding and cost-efficient service," which is a clear statement on both its policy purpose and business goal. (I was unable to identify a similar recent government statement on Hydro One's public policy purpose or ownership plan.) An updated mandate statement from Queen's Park might also address Hydro One's role in the global energy transition and reducing Ontario's GHG emissions.

In the face of the heavy-handed events three years ago, Hydro One deserves high marks for its commitment to strong corporate governance practices, which are important in building the confidence of investors, customers and stakeholders and building long-term private and public shareholder value.

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