Ministry of Energy – Proposed Member Questions:

1. **To the Deputy Minister of Energy, why is keeping the financing costs of Ontario's Fair Hydro Plan (OFHP) on the rate-base, as opposed to the tax-base appropriate?**

   And, why is Ontario Power Generation (OPG) best placed to minimize the cost of the overall program from your perspective?

   Thank you for the question.

   In responding to the question I'd like to give some background and the evolution of Ontario's electricity sector to provide some important context for the OFHP.

   Over the last decade Ontario has rebuilt our transmission and distribution grid, invested in clean generation, and closed the last coal-fired power plant. The government has been making important investments in a cleaner and more reliable electricity system, but these investments have led to higher bills. Since 2003, nearly $70 billion[1] has been invested in the electricity system, including more than $37[2] billion in electricity generation to ensure the system is clean and reliable.

   Ontario's Fair Hydro Plan has introduced new measures to lower electricity bills by 25 per cent on average for residential consumers and will hold increases to the rate of inflation for four years. As many as half a million small businesses and farms are also benefitting from a reduction.

   In the development of Ontario Fair Hydro Plan, the government made the decision to provide rate relief to specific residential consumers though the introduction of new and enhanced electricity social programs, such as OESP and RRRP. At the same time, the government also made a policy decision that these new measures would be more appropriately funded from the tax-base, not the rate-base. In addition, a policy decision was made to refinance the Global Adjustment over a longer amortization period that better reflects the life of the assets.

   To better understand the Ontario Fair Hydro Plan, it is important to unpack the key components of the plan in more detail. I like to group these components into three buckets:

The first bucket is the Ontario Rebate for Electricity Consumers (OREC) program

The second bucket is enhancing electricity support programs and shifting costs off the electricity bill from the ratebase to the tax base.

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[1] Ministry of Energy, *2017 Long-Term Energy Plan*
[2] Ministry of Energy, *2017 Long-Term Energy Plan*

The third bucket is refinancing the Global Adjustment (GA) over a longer term period of time to better align cost recovery with the useful life of generation assets.

Now, I'll go into more detail on each of the three buckets:

On January 1, 2017, the government introduced the Ontario Rebate for Electricity Consumers program which provides financial assistance to eligible consumers in respect of electricity costs. The rebate is equal to eight per cent (8%) of the base invoice amount which is equivalent to the provincial portion of the Harmonized Sales Tax (HST) on the bills of residential, farm, small business and other eligible customers. That's an 8% rebate provides an average savings of approximately $130 annually or $11 each month. The rebate is available to all consumers eligible for the Regulated Price Plan (RPP) – this includes about five million residential consumers, small businesses and farmsThe OREC has an approved 2017-18 expenditure of $939M.

The second bucks of initiatives consists of enhancing electricity social programs and shifting costs to the taxbase.

Helping vulnerable electricity consumers by enhancing electricity support programs and shifting costs off the electricity bill. Eligible electricity consumers will receive additional support through the following programs:

A new Affordability Fund which will support Ontarians who are not eligible for the Home Assistance Program and who have difficulty paying their electricity bills.

of the old Ontario Hydro and has existed in its current form since 2001. About 800,000 customers now benefit from the enhanced rate protection. Residential customers from the following LDCs benefit from the broadened rate protection: Hydro One low density (R2) and medium density (R1) customers,, Northern Ontario Wires, Lakeland Power (Parry Sound),), Chapleau Public Utilities Corporation, Sioux Lookout Hydro, InnPower, Atikokan Hydro and Algoma Power.

Expanding the Ontario Electricity Support Program (OESP) to increase participation and provide further assistance to eligible participants.

These changes came into effect on May 1, 2017 and included increasing on-bill credits by 50 per cent and expanding eligibility so more Ontarians are eligible.

This program is available to households that receive electricity bills and meet the household size and income eligibility criteria. Monthly, on-bill credits of $35-75 are available to eligible applicants, and for those with additional energy needs, the credit ranges from $52-113.

In January this year, over 220,000 OESP credits were issued to households across the province.

Since July 1, 2017, the First Nations Delivery Credit has provided on-reserve First Nations households who are customers of licensed electricity utilities a credit equal to 100 per cent of the electricity delivery charge on their electricity bills.

The First Nations Delivery Credit helps address some of the unique challenges that on-reserve First Nations customers face and recognizes First Nations' contribution to the provincial electricity system.

Data reported by the Independent Electricity System Operator indicates that over 20,000 customers are receiving the credit, which was the target pre-launch and reflects a successful rollout.

All of these new and enhanced rate mitigation programs in the two buckets are funded by the taxbase at total cost of about $1.5 billion annually.

And now I'd like to discuss the third bucket – refinancing the global adjustment.

To reduce pressure on today's electricity consumers, a portion of Global Adjustment (GA) costs is being refinanced. In later years, the cost of the re-financing will be recovered from electricity consumers and not taxpayers.

Refinancing the Global Adjustment (GA) is providing significant and immediate rate relief by spreading the cost of electricity investments over the expected lifecycle of the infrastructure that has been built. The majority of the province's electricity generators have 20-year contracts. Many of these generators will be able to operate past their contract term, meaning that generating assets are expected to have ongoing useful life and will benefit future ratepayers by reducing the need to finance the development of new generating assets.

Electricity bills have been reduced for current ratepayers, and future ratepayers will in turn pay for their fair share of the significant investments that have been made to build a clean and reliable electricity system. This more fairly shares the cost of these investments across the generations of electricity ratepayers who will benefit from them.

Given that the policy objective of Ontario Fair Hydro Plan (OFHP) is to more fairly allocate the cost to ratepayers over the useful life, not the contractual term, of the electricity generating assets, it was a primary policy objective to ensure that the costs are borne by the beneficiaries of the electricity system – the rate-base – not the tax-base.

In addition, the rate-base has a different risk profile than the tax-base, which is reflected in different financing costs. Having the rate-base pay for financing of electricity system assets is not a new policy; for example Hydro One has borrowed in the capital markets since the early 2000s.

Based on this policy decision, it was decided that the debt obligation would be recognized as a regulatory asset that would be sold and securitized. This design appropriately aligns the costs and benefits within the group of eligible electricity consumers.

Development of Ontario Fair Hydro Plan (OFHP)

In developing the policy to refinance the Global Adjustment (GA), the government considered a range of implementation options, including the appropriate life of the assets and amortization period. Senior officials and staff from several departments and agencies, led by the Ministry of Energy, collaborated to plan a structure, identify risks and take necessary actions to meet the mandate.

The senior officials and staff included:

- Ministry of Energy;
- Ministry of Finance;
- Treasury Board Secretariat;
- Office of the Provincial Controller;
- Cabinet Office;
- Ontario Financing Authority (OFA);
- Independent Electricity System Operator (IESO); and
- Ontario Power Generation Inc. (OPG).

The government also consulted with legal, accounting, financial and energy sector third-party experts to provide advice and ensure due diligence was completed. This is normal course of business governments take for complex transactions.

Role of Ontario Power Generation (OPG)

With respect to Ontario Power Generation (OPG), it was identified as the Financial Services Manager (FSM) responsible for the financing plans and the financing entity (i.e., Fair Hydro Plan Trust) that will manage the debt obligations associated with Global Adjustment (GA) refinancing. Financing requirements are determined by the legislation and will be funded through the Trust.

Ontario Power Generation (OPG) is uniquely positioned to be the Financial Service Manager (FSM), it understands the characteristics of the market, regularly interacts with the Ontario Energy Board (OEB) and the Independent Electricity System Operator (IESO).

Ontario Power Generation (OPG) has extensive experience in the Ontario energy market, capital markets, regulation and fund management and will ensure that the refinancing will be done in the most efficient and cost-effective manner.

Ontario Power Generation (OPG) currently manages approximately $20 billion in nuclear funds through the Decommissioning Segregated Fund and the *Used Fuel Segregated Fund* to manage nuclear liabilities, $15 billion in pension funds and is an electricity sector entity regulated by the Ontario Energy Board (OEB) with extensive experience in regulatory deferral and variance accounts.

Ontario Power Generation (OPG) has a demonstrated track record in the financial markets with its Corporate Debt platform, private placement of insurance linked bonds, participation in securitization programs and highly successful project debt issuances tied to new hydroelectric developments. These financing initiatives have been well received by investors at a reasonable cost to Ontario Power Generation (OPG). The innovative, cost saving and precedent setting aspects of these structures have resulted in international recognition.

In addition to executing hundreds of millions in project financing over the past several years, Ontario Power Generation (OPG) completed its first bond offering in the Canadian public market with $500 million unsecured 10-year bonds in October 2017.

Ontario Power Generation (OPG) has developed solid investor relationships and has a large investor base in the structured finance space that comprises the target market for financing Ontario's Fair Hydro Plan (OFHP) initiative. For example, the Lower Mattagami project financing attracted a broad investor base of ~80 institutional investors, including major investors in the Canadian power and utility bonds markets.

Ontario Power Generation (OPG) has a strong track record of producing high-quality financial reports on a timely basis. In addition, Ontario Power Generation (OPG) will report on the activities of the Fair Hydro Trust in its quarterly financial reporting. The Fair Hydro Trust will be reported as a separate segment in these public documents

In terms of administration, Ontario Power Generation (OPG) is currently managing its own corporate public debt program, three project financing programs totaling more than $2 billion and two commercial paper programs.

Finally, Ontario Power Generation's (OPG) Treasury functions are well positioned given their management of existing multiple debt programs.

As the implementation of the financing program progresses, focus has remained on minimizing costs to ratepayers. Particular attention has be given to achieving a strong credit rating for the Trust, with the objective of mitigating the impact to ratepayers through effective market pricing of the funds being borrowed by the Trust.

Ontario Fair Hydro Plan (OFHP) is delivering much-needed rate relief to electricity consumers. The policy decisions we have made in implementing Global Adjustment (GA) refinancing, in consultation with third-party experts, senior officials and staff from across government, most effectively achieve the policy goals of the refinancing program and ensure that the cost of important investments in the electricity system are allocated fairly amongst electricity consumers in proportion to the benefit from received from them.

1. **To Independent Electricity System Operator (IESO), how did IESO come to the conclusion that it was acceptable to use US Generally Accepted Accounting Principles (GAAP) instead of Public Sector Accounting Standards (PSAS) for rate regulated activities?**

   And, is there a clause or section of PSAS that permits the use of GAAP in a given scenario?

   <u>Response</u>

   <u>Independent Electricity System Operator's Approach to Accounting</u>

   The Independent Electricity System Operator (IESO) follows Public Sector Accounting Standards (PSAS) for its accounting.

   The PSAS neither explicitly permits, nor prohibits, the recognition, measurement, presentation or disclosure of rate-regulated activities. In absence of a clear position on an issue, standard accounting practice dictates that an entity is entitled to consult another accounting standard. If I may cite from the PSAS Handbook, Section 1150.18 and 19:

   > *"Paragraphs PS 1150.19-.24 identify some of the other sources that a public sector reporting entity might consult to assist in selecting*

> *accounting policies and disclosures that comply with paragraph PS 1150.05.Pronouncements issued by other bodies authorized to issue accounting standards may be useful sources to consult.*
>
> *For example, accounting pronouncements published with the authority of the Canadian Accounting Standards Board (AcSB), International Accounting Standards Board (IASB), US Federal Accounting Standards Advisory Board (FASAB), US Governmental Accounting Standards Board (GASB), or International Public Sector Accounting Standards Board (IPSASB) are often important sources to consult on matters not covered by primary sources of GAAP or for assistance in applying a primary source of GAAP to specific circumstances."*

In this case, IESO consulted US GAAP, the only accounting framework in North America that provides guidance on rate regulated operations. The IESO has since adopted aspects of the US GAAP accounting framework allowing IESO to recognize a regulatory asset.

This decision was supported by an accounting opinion from our external auditors at KPMG and aligns IESO with six of the eight other independent system operators in North America.

It's a decision IESO made after careful consideration and extensive consultation with external experts. In fact, more than one of the big-four accounting firms agree with our decision on this matter. The IESO regularly reviews its accounting policies to ensure our financial reporting best represents our operations and the substance of the accounts we oversee.

Prompted by conversation with government about Ontario's Fair Hydro Plan (OFHP) and recognizing the need to consider impacts of future government policy, IESO revisited its options for reporting market accounts and recognizing regulatory assets.

Working with its audit partner KPMG, IESO determined that there were reporting options for market accounts and regulatory assets and that a choice was required as to whether or not to report these in IESO financial statements.

By analyzing the nature of the accounts, IESO's economic relationship to them, legislative requirements and market rules it was concluded that an appropriate position for either treatment was acceptable.

Organizations in Other Jurisdictions

When we started looking into changes to our accounting policies, we wanted to look at other organizations that have similar mandates to us.

Including IESO, there are 9 independent system operators in North America; seven in the U.S. and two in Canada: The IESO and Alberta's AESO.

We had discussions with these organizations about their operations and accounting practices.

We looked at their location, the accounting framework they follow, the type of organization they are (either not-for-profit or otherwise), whether they are subject to income tax, their capital structure, how they are governed, by which body they are regulated, and finally, whether they recognized balances of market participants and regulatory assets in their financial reporting.

From this research, we found that 7 of the other 8 ISOs recognize the balances of the market participants. They are:

1. **ISO New England;**
2. **NYISO**, in New York;
3. **MISO**, Midcontinent ISO which covers Midwest United States, Manitoba, and much of Arkansas, Mississippi and Louisiana;
4. **PJM**, covering the eastern U.S. states: Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia;
5. **CAISO**, in California;
6. **ERCOT**, in Texas; and
7. **Southwest Power Pool**, in central US.

When we talked to our counterparts across North America about regulatory assets, we found out that 6 of the other 8 entities recognize the economic effects of rate regulation, they are:

1. **AESO**, in Alberta;
2. ISO New England;
3. NYISO;
4. MISO;
5. PJM; and
6. ERCOT.

I should mention that the two ISOs that do not recognize the effect of rate regulation are California ISO (CAISO) and Southwest Power Pool (SPP).

When we talked to CAISO, we found out that their accounting framework actually allows for the recognition of regulatory assets and liabilities, but that it had concluded the need to recognize regulatory assets was no longer necessary.

When we talked to Southwest Power Pool, we learned that they simply do not have any variance accounts that would qualify as regulatory assets or liabilities.

So, when we looked at making the accounting change we considered that:

1. Including **market accounts** on our financial statements would provide increased transparency into the value of transactions that flow through Ontario's $17 billion electricity market;
2. That **regulatory accounting** better reflected the economic substance of certain types of IESO expenses (like Smart Metering Entity expenses) which are recovered through a rate regulated by the OEB;
3. That the change would **enhance the relevance, transparency and accountability of our financial reporting**;
4. That this change would **bring IESO in line with its peers** across North America; and
5. Finally, that this accounting change would in **no way affect IESO's costs, or have any financial impact on electricity ratepayers –** all these factors confirmed our decision to make the accounting change.

Ultimately, IESO felt the public reporting of market accounts was relevant to the needs of its financial statement users and enabled greater transparency into the market transactions it oversees, which amounted to $17 billion last year.

We also felt that recognizing regulatory assets would provide more transparency into the substance of the variance accounts we oversee.

As we just covered, this change to recognize regulated assets and market accounts brings IESO in line with accounting practices followed by other independent system operators in North America.

I should also mention, that in the past, the Ontario Power Authority, a predecessor organization of IESO, reported a subset of the market accounts on its financial statements – so this isn't new.

Role of an Independent Audit Firm

To confirm our view that the change was appropriate, IESO engaged independent audit firm KPMG for accounting research on the matter.

KPMG conducted its own research into the issue. KPMG subsequently issued a white paper on the accounting change, supporting IESO's decision to change its accounting policy. The changes were also reviewed with and supported by the Office of the Provincial Controller.

The accounting change was reviewed by IESO's Board of Directors, and approved.

As part of our regular 2016 year-end audit, KPMG issued an accounting opinion on our financial reporting. The accounting firm issued an unqualified or "clean" accounting opinion, meaning they supported the decision.

Finally, when publishing our 2016 financial statements, in order to communicate the change of accounting policy, IESO added additional notes in its 2016 financial statements to explain the changes in the Summary of Significant Accounting Policies section of its 2016 annual report.

These changes in no way affect IESO's costs, or have any financial impact on electricity ratepayers.

Ultimately, IESO made these changes because it will provide the users of its financial statements greater transparency into the market transactions it oversees, which amounted to $17 billion last year, and better reflects the economic substance of IESO expenses that are recovered through rate-regulation.

It is KPMG's responsibility to express an opinion on the financial statements based on their audit.

In our case, KPMG conducted their audit in accordance with Canadian generally accepted accounting standards.

Those accounting standards require that the auditors comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the entity's financial statements are free from material misstatement.

Here are some of the things an audit looks into:

- An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.

- The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

- In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

In addition, an audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

In IESO's 2016 financial statements, KPMG stated: "We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion".

This was followed by a statement of their unqualified opinion:

- In our opinion, the financial statements present fairly, in all material respects, the financial position of IESO as at December 31, 2016, and its results of operations and the changes in its new debt and its cash flows for the year then ended in accordance with Canadian public sector accounting standards.

This is taken directly from our 2016 financial statements, which are publically available.

So the "unqualified opinion" is basically accounting-speak to say that the audit partner undertook the thorough audit process, applied the appropriate standards and believes the financial statements follow the appropriate accounting standard and fairly and accurately represent IESO's financial position at year-end.

KPMG also found that US GAAP was an appropriate accounting framework to look to for guidance on rate-regulated operations, since PSAS was silent on the issue. And that regulatory assets under ASC 980 is not an exemption from the application of US GAAP.

Finally, KPMG's research also found that the accounting change would bring IESO in line with the majority of its ISO peers across North America.

When we considered the results of our own and KPMG's research, along with the fact that the change would have no impact on IESO's costs, or have any financial impact on electricity ratepayers, we went ahead and made the accounting change.

2. To Ontario Power Generation (OPG), can you explain what sort of external expertise OPG enlisted?

And, can you explain what counsel these experts provided with respect to the structure that has been set up and the accounting that will be used?

Response

Ontario Power Generation's Qualifications

Let me make a few remarks about Ontario Power Generation's (OPG) qualifications as the financing manager of Ontario's Fair Hydro Plan.

OPG currently manages a $20 billion nuclear fund and $15 billion in pension funds and as an entity regulated by the Ontario Energy Board (OEB), OPG also has extensive experience with regulatory deferral and variance accounts.

In addition, OPG has the breadth and demonstrated track record in the financial markets including the highly successful inaugural public debt offering earlier in October, private placement of insurance linked bonds, participation in securitization programs, and the very successful project debt issuances tied to new hydroelectric developments.

These financing initiatives have been well received by investors at a reasonable cost to OPG. The innovative, cost saving and precedent setting aspects of these financing structures have resulted in international recognition.

OPG has also developed solid investor relationships and has a large investor base in the structured finance space who would be the target market for financing Ontario's Fair Hydro Plan initiative.

For example, the Lower Mattagami project financing attracted a broad investor base of about 80 institutional investors, including major investors in the Canadian power and utility bonds market.

In terms of administration, OPG is currently managing its own Corporate public debt and three project financing programs totaling more than $2 billion, as well as two commercial paper programs.

Role of Ontario Power Generation as the Finance Service Manager

OPG is acting as the Finance Service Manager (FSM) as prescribed under the Ontario Fair Hydro legislation, assigned to develop the financing plans and manage the Fair Hydro Trust, which manages the debt obligations associated with Global Adjustment (GA) refinancing.

In December we set up the Fair Hydro Trust, which is ring fenced from the generation activities of OPG in an effort to reflect the unique nature of this business and not co-mingle the operational activities of the two businesses.

The financing requirements are determined by the legislation and the reduction in consumers' bills, and are funded through the Trust.

OPG is responsible for arranging for third party debt to finance the purchase of the regulatory asset from IESO. This funding will be supplemented by both the Province and OPG.

- The first tranche of public debt was issued in early February 2018.

- The Trust will continue to borrow funds through the debt markets 3-4 times each year to purchase assets from Independent Electricity System Operate (IESO).

OPG is uniquely positioned to be the financing manager of Ontario's Fair Hydro Plan as we understand the supply and demand characteristics of the market. As previously mentioned, we regularly interact with the Ontario Energy Board (OEB) and the IESO, and we have experience in Treasury operations in the marketplace including relationships with credit rating agencies.

There are three specific areas that we supplemented our team with external resources.

- First, was legal advice to ensure there is clear alignment between the legislation and the Trust and its related requirements and obligations.

- The second was financing advice directed at the capital markets again to ensure alignment with the markets focused on achieving the most cost effective financing to ensure the rate payer impact is minimized.

- The third was accounting advice directed at the set up and governance of the Trust and then to achieve the transparency in reporting that is critical.

<u>*Greater Transparency*</u>

As has been mentioned OPG has strong capabilities across these areas, but felt it was prudent to ensure that all steps are taken to establish the Trust and its activities in a clear and transparent manner.

The structure that has been set up in fact ensures a high level of transparency.

As these deferred amounts are funded through third party financing, the process by design in financial market space requires disclosure and oversight including credit rating agencies, the OEB, external audit of the Trust itself, additional OPG disclosure in its reports, oversight from lenders through Trust indenture documents.

Ratepayers and taxpayers will be able to clearly see the financial results of the Trust as it relates to the legislation.

Due to OPG's ownership and control over the key activities of the OPG's Fair Hydro Trust, OPG will consolidate the financial results of the Trust in accordance with US GAAP.

OPG will report the financial results of the Trust's operations as part of its regular quarterly and annual reporting process, beginning in March 2018.

The Trust's activities will be clearly reported as a separate segment in OPG's overall results.

OPG's financial reports are audited (currently by ERNST & Young) and filed with the Ontario Securities Commission (OSC) and subject to OSC oversight and a public news release is always issued when the reports are filed.