CABINET BRIEFING NOTE
AND LRC RECOMMENDATION

Energy
Fair Hydro Plan Implementation

DRAFT

Based on draft materials

Cabinet (info) Feb 15, 2017	TB/MBC and Cabinet March 1, 2017	Announcement March 2, 2017	TB/MBC May 9, 2017	Cabinet May 10, 2017
Introduction May 11, 2017	Royal Assent June 1, 2017	TB/MBC June 27, 2017	Cabinet (DTC) June 14, 2017	Cabinet (DTC) June 27, 2017
Program Effective Date July 1, 2017	TB/MBC September 25, 2017	Cabinet September 27, 2017	Cabinet (DTC) October 18, 2017 (TBC)	

Summary of Proposal

The proposed regulations are consistent with Cabinet direction.

Context for Decision:

On March 2, 2017, the government announced Ontario's Fair Hydro Plan (OFHP). One component of the OFHP is refinancing a portion of the Global Adjustment (GA). The implementing legislation for GA refinancing, the *Ontario Fair Hydro Plan Act, 2017* (OFHPA), was introduced May 11, 2017 and received Royal Assent on June 1, 2017. The OFHP expands the powers of Ontario Power Generation (OPG), the Ontario Energy Board (OEB) and the Independent Electricity System Operator (IESO) and puts in place mechanisms including appropriate payment settlement and cost-recovery authorities for and through the IESO to manage the deferred GA costs.

On June 14, 2017 new regulations were created under the OFHPA that support calculations related to GA refinancing and one regulation was amended to authorize IESO to borrow to fund the regulatory asset as part of the financing structure. On June 27, 2017 a new regulation was created under the OFHPA that details the roles and responsibilities of the Financial Services Manager (i.e., OPG), IESO and OEB.

Commented [MK(1]: Is this the reg that is being amended?

Commented [JK2R2]: The following section confirms this.

Proposal:
This proposal is the next step in the implementation of GA refinancing. The Ministry of Energy (ENERGY) is proposing amendments to O.Reg. 206/17 (i.e., general regulation) under the OFHPA that would:

1. Enable OPG, as Financial Services Manager (FSM) to establish and charge fees, once approved by the OEB, for the services it provides as part of the government's approach to GA refinancing.

2. Enable OPG, as FSM to recover "carrying costs" (i.e., fees and interest amounts) from IESO during the "inflationary cap period" from July 1, 2017 to April 30, 2021.

Why does Ontario need these changes? Why now?

Addressing rising electricity prices is among the highest priorities for Ontarians. The OEB adjusted rates to reflect the OFHP reductions partially on May 1, 2017 and fully on July 1, 2017. The IESO has been managing the GA deferral with its existing resources since reductions have been in place. As such, it is important for the proposed amendments to take effect in a timely manner to enable OPG to go to market to fund the GA deferral by transferring the regulatory asset to the OPG financing entity. ENERGY understands that OPG intends to go to market in November 2017 and is currently in preliminary discussions with rating agencies with respect to timing and other aspects of its FSM role.

How will this proposal impact Ontario?

Under the OFHPA, which enables GA refinancing, electricity bills for a typical residential consumer have been reduced by 25 percent effective July 1, 2017, compared to what they would have been without the initiatives included in the OFHP. The OFHPA also provides that further increases to electricity bills for a typical consumer are to be held to the rate of inflation for four years.

The proposed amendments would support the implementation of the OFHP, which affects all specified consumers to whom the "Fair Adjustment" applies. Prescribed consumers under the OFHP include residential consumers, farms, small businesses, condominiums, long-term care homes and co-operative housing. These are primarily consumers eligible for the Regulated Price Plan (RPP), and aligns with the eligibility under the *Ontario Rebate for Electricity Consumers Act, 2016* (ORECA). ENERGY notes that up to 500,000 small businesses and farms are benefitting from GA refinancing.

What is the expected cost to government?

Commented [TR(3]: Is TB/MBC approval required?

Commented [TR(4]: Are the proposed amendments expected to have any ratepayer impacts, for example through FSM fees? Can estimated impacts be provided?

Commented [TR(5]: Can estimated fees range that the FSM could charge be provided?

The GA refinancing structure, as designed, results in: (1) an increase in provincial gross debt (to finance the equity injection in OPG), with no increase to net debt, as the gross debt increase is offset by an increase in the government's assets in the form of a higher equity investment in OPG, and (2) an increase in interest on debt paid by the Province, assumed in the fiscal plan as exactly offset by higher earnings from OPG, resulting in no assumed impact to the Province's fiscal position. The actual impact will depend on actual IOD and OPG net income impacts. The proposed regulations would support the implementation of this refinancing structure. According to ENERGY, the proposed amendments would not result in any incremental material net fiscal impact on the finances of the Province [TBC].

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Allowing OPG to recover carrying costs from IESO during the "inflationary cap period" from July 1, 2017 to April 30, 2021, is expected to have no net impact to specified consumers within this period. As with other costs under the scheme, these IESO costs would be deferred to future collection from specified consumers on and after May 1, 2021.

What are the key steps to deliver this proposal?

The proposed regulations would take effect [NTD: placeholder for timelines].

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Amendments would provide further detail on the roles and responsibilities of the OPG, IESO and OEB with respect to GA refinancing. Key steps for the delivery of this proposal include:

- OPG to produce Financing Plans that set out funding obligations for each reference period consistent with the Fair Allocation Amount (FAA).
- IESO to record deferral amounts in relation to the establishment of the regulatory asset.
- OPG financing entity to begin purchasing monthly regulatory assets from the IESO November 2017 and work with lenders and credit rating agencies in establishing vehicles for securitizing (selling) of investment asset interests.
- OPG management fees and interest costs to be recovered from IESO July 1, 2017 to April 30, 2021.
- OPG management fees and interest costs to be recovered by specified consumers through Clean Energy Adjustments (CEAs) on and after May 1, 2021.
- OEB to review OPG management fees as per the methodology established in regulation and determine the rates that will be applied to specific consumers beginning in 2018/2019.

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Commented [JK9R9]: Timing of recovery and mechanisms are clarified in the later sections for these bullets.

How will the changes be communicated?

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[NTD: CO Comms to provide]

Notes and Recommendation from LRC

N/A – item proceeding direct to Cabinet.

Cabinet Office Analysis

The Ministry of Energy's (ENERGY) proposed amendments to O.Reg. 206/17 are consistent with Cabinet direction provided for the implementation of GA refinancing as part of Ontario's Fair Hydro Plan (OFHP) on March 1, 2017. The *Fair Hydro Act, 2017*

(OFHPA) establishes the framework to refinance a portion of current Global Adjustment (GA) costs as part of the OFHP. The OFHP reduced a typical residential consumer's electricity bills by 25 percent, on average, effective July 1, 2017, compared to what they would have been without the initiatives under the Plan. The refinancing methodology defers a portion of current GA costs to future ratepayers in order to allocate costs across present and future generations of electricity consumers with respect to investments made to decarbonize (e.g., phase-out coal) and modernize Ontario's electricity system (e.g., build and maintain a reliable electricity system).

Refinancing Structure

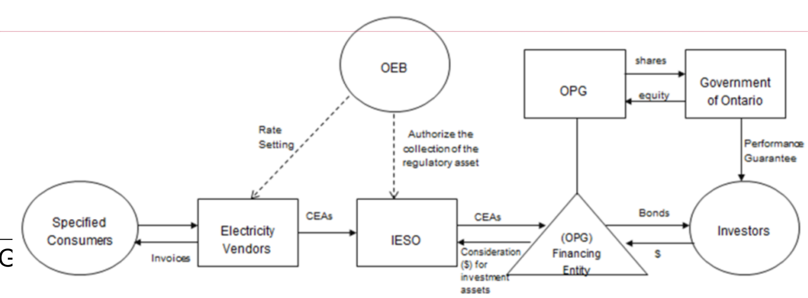
Under the GA refinancing structure, the Independent Electricity System Operator (IESO) records the GA cost recovery deferral as a "regulatory asset" to be collected at a future time from "specified consumers" (in rates regulated by the Ontario Energy Board (OEB)) ("the Fair Adjustment" and "IESO deferral"). As a result, specified consumers will receive a reduction in electricity rates from July 1, 2017 to June 30, 2018. IESO may then sell the regulatory asset, at which time it becomes an "investment asset" in the OPG financing entity.

The Minister of Energy, following the principles in the Act and regulations, will regularly calculate the "Fair Allocation Amount" to ensure a proper alignment of the allocation of the intergenerational costs and benefits in relation to each of the next 60 six month "reference periods." Based on the Fair Allocation Amount, the Financial Services Manager (OPG), through financing entities, will debt finance a portion of the GA costs. The financings will be backed primarily by the clean energy adjustments payable by specified consumers. The clean energy adjustments will track the actual payment obligations incurred by the financing entities when they become due and payable.

OPG, in its role as the Financial Services Manager (FSM), will calculate the aggregate clean energy adjustment payable in each month of the reference period, and, to ensure intergenerational fairness, these amounts will be managed to ensure consistency with the fair allocation amounts. OEB will calculate the rates at which the clean energy adjustment will be collected from specified consumers.

To recoup the costs associated with the fair adjustment, consumers will be invoiced the clean energy adjustment on their electricity bills through existing IESO and Local Distribution Companies' (LDC) processes, which will be channeled through to pay each financing entity's related funding obligations. The clean energy adjustments will appear on customer's bills once repayment of the accumulated debt begins.

Commented [AS11]: I believe an updated diagram has been circulated which uses the more current language for the Performance Guarantee: now referred to as a Provincial Protection Agreement



Note: CEAs are "clean energy adjustments".

Proposal

In its capacity as FSM under the GA refinancing structure, OPG will take on the risk and responsibility of financing the deferral, with the financing entity purchasing monthly regulatory assets from IESO. OPG will finance these purchases through a combination of an equity investment by the Province and external private sector financing. The proposed regulatory amendments would enable OPG to go to market to fund the GA deferral:

Management Fees: As FSM, OPG is allowed to charge a management fee for its services made up of a base fee, variable fee and Third-party costs (e.g., banking fees). The proposed amendments to O.Reg. 206/17 would establish a methodology for calculating and reviewing FSM management fees. OPG's base fee for 2017/18 would be established at 7.5 basis points. The OEB would be responsible for determining FSM management fees for future years by reviewing fees for comparable services through the use of an outside expert..

Carrying Costs: OPG must recover management fees and interest costs (i.e., "Carrying Costs") beginning July 1, 2017 to ensure the implementation of GA refinancing satisfies accounting requirements. These costs however, cannot be recovered from specified consumers during the "inflationary cap period" from July 1, 2017 to April 30, 2021 in order for GA refinancing to proceed as planned under the OFHPA without significantly increased costs passed through to the specified ratepayers. The proposed amendments to O.Reg. 206/17 would enable the recovery of these costs by OPG from the IESO during this period. These costs would form part of the variance account for future collection from specified consumers and would be recovered through the CEAs on and after May 1, 2021.

Commented [KK12]: The base fee is explained, perhaps there should be an explanation of the variable fee as well.

Commented [TR(13]: Please confirm and provide rationale for this fee structure

Commented [KK14]: My understanding was that only the base fee will be reviewed by the OEB.

Commented [TR(15]: Would the OEB also have a role in determining fees beyond the base fee? Would fees be determined through the OEB's hearing process?

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Commented [TR(18]: Please confirm total expected amount for costs during this period, $500k-1M?

Stakeholder response:

ENERGY consulted with representatives from the OEB, IESO an OPG, as well as external advisors (i.e., lawyers and accountants) and other ministries as appropriate on the proposed regulatory amendments. Consistent with the approach taken to develop and implement the OFHPA, a steering committee chaired by ENERGY's Deputy Minister met bi-weekly on the status of the proposed regulatory amendments. The committee consists of senior executives from ENERGY, Cabinet Office, Ministry of Finance, Treasury Board Secretariat, Ontario Financing Authority, OPCD, OPG, OEB and IESO.

General public (Neutral) – Generally supports the GA refinancing initiative, but also question the longer term implications. Some individuals and organizations perceive the GA smoothing as unduly burdening future generations.

OPG-

OEB-

IESO-

Risks:

OPG/SPV Mechanism

There are several risks associated with the OPG/SPV mechanism that remain. OPG/SPV could continue to be criticised for not having an appropriate level of accountability to the government or the public, due to the limited amount of government control of the entity, and future rate increases. However, this is seen by the markets as an essential component for the structure to operate and the government remains the sole shareholder of OPG.

Proposed regulations build on a complex financing structure that is unique to Canada—uniqueness reduces likelihood of all risks being known/mitigated. Highly specialized expertise has been required to get to this point. External private sector financing is still not certain.

Legal

In principle, refinancing the GA to spread the costs of generation and conservation assets over the useful life of the assets presents only a low risk of being an unconstitutional tax, as each cohort of consumers pays for a proportion of the GA cost roughly equal to the proportion of the benefit they receive from the useful life of the assets. Legal risk arises if it becomes apparent that the government is not spreading cost so that it is shared proportionately by future consumers who cause a need for or benefit from the asset, but rather is doing so in order to lower the price in the short term by increasing the price in the long term. If the proposed financing served to encumber future consumers with a premium payment to cover the GA financing in order to subsidize current ratepayers, then there would be a moderately high constitutional risk that the financing proposal would result in an unconstitutional tax.

The legislation contains provisions to mitigate the constitutional law risks, including requiring the Minister of Energy to reallocate estimated clean energy costs attributable to each reference period in a way that takes into account the need to align those costs with the estimated clean energy benefits attributable to the same period.

Linkages:
Long-Term Energy Plan (LTEP) – Ontario is preparing to release a new LTEP in October / November 2017. The LTEP identifies needs for investments over the shorter term, while broadly mapping out the direction of the sector over a 20 year timeframe. The LTEP is

Commented [TR(19)]: What is OPG's view on the proposed amendments?

Commented [TR(20)]: What is the OEB's view on the proposed amendments?

Commented [TR(21)]: What is the IESO's view on the proposed amendments?

Commented [TR(22)]: Are there any risks associated with the proposed management fees, for example rate impact or perception?

Commented [TR(23)]: Are there any accounting risks associated with the proposed amendments?

Commented [TR(24)]: Are the amendments expected to have an impact on the financeability/saleability of the investment asset?

Commented [TR(25)]: Do the proposed amendments introduce any new risks with respect to the OPG/SPV mechanism?

Commented [TR(26)]: Does the role of the OEB in overseeing OPG fees take into account the risk that OPG could make the case to be exempted from compensation rules because there is no national comparator for this aspect of their work?

intended to balance the principles of affordability, reliability, clean energy, community and Indigenous engagement, as well as conservation and demand management.

Electricity Rate Mitigation Initiatives – The *Ontario Rebate for Electricity Consumers Act, 2016*, (ORECA) put in place a rebate for an amount equivalent to the 8% provincial portion of the HST for eligible residential, small business customers and farms, beginning January 1, 2017.

Rural and Remote Rate Protection (RRRP) and Delivery Rate Protection (DRP) – RRRP and DRP help to offset the higher costs to distribute electricity to Ontario residents who live in rural or remote locations all across the Province. DRP was established under the FHA and regulations approved June 14, 2017. Both the expanded RRRP and DRP were implemented July 1, 2017.

The Ontario Clean Energy Benefit (OCEB) – Was a five-year legislated program put in place as a broad-based, transitional measure to a cleaner electricity system. OCEB was also put in place following the implementation of the Harmonised Sales Tax (HST). Unlike the previous provincial Retail Sales Tax (RST), the HST (and GST) included electricity in the taxable base. OCEB program ended on December 31, 2015.

Debt Retirement Charge – On January 1, 2016, the government ended the electricity DRC on residential users, which was earlier than previously estimated. For all other consumers the DRC will be removed by April 2018, also earlier than previously estimated.

Industrial Conservation Initiative (ICI) – Implemented in January 2011 to help large industrial consumers reduce electricity costs by reducing consumption in peak periods. ICI eligibility has been expanded several times, and was most recently expanded, as part of the OFHP, to allow for the participation of the manufacturing and, e.g., greenhouse sectors with an average month peak demand down to a range of greater than 500 kilowatts (kW) and less than or equal to 1 megawatt (MW). ICI provides a benefit to all consumers by decreasing the need for costly peaking generation over the long term.

Affordability Fund – Approved as part of OFHP, and under development, the Affordability Fund is intended to provide energy efficiency measures to Ontarians who are not eligible for low income conservation programs, and who are otherwise unable to make energy efficiency improvements without financial assistance.

Ontario's Climate Change Action Plan (CCAP) – The CCAP, released in summer 2016, reiterated the 2016 Budget commitment and stated that Ontario intends to invest in initiatives that both reduce greenhouse gas (GHG) emissions and ensure that the net impact of cap and trade would not result in an overall increase in electricity costs for commercial and industrial consumers, and that there would be a modest benefit of up to $2 per month, on average, to residential consumers. This commitment to residential consumers was exceeded by the January 2017 8% rebate.

Other Jurisdictions:

According to ENERGY, no other jurisdictions have comparable legislative and regulatory frameworks. The U.S. does have examples of securitizations involving single distribution companies, but none of the transactions would have approached the level of complexity involved with the present OFHPA initiative.

Terms you need to know

- **Global Adjustment (GA) –** The GA accounts for the difference between generation costs (contracted and rate-regulated) and the wholesale market price in order to recover fixed costs, including capital costs, of putting in place and operating Ontario's generation fleet, as well as the cost of conservation and demand management programs. The GA is instrumental in maintaining a reliable electricity system by ensuring that sufficient generating capacity is available.
- **Local Distribution Companies (LDCs) –** Local electricity utilities (e.g., Hydro Ottawa, Toronto Hydro, etc.) responsible for distributing power from transmission lines to people's homes and to businesses and institutions. LDCs recover their costs through distribution rates. LDCs are licensed to serve a specific geographic area by the Ontario Energy Board (OEB). An LDC must receive OEB approval to charge a distribution rate.
- **Regulated Price Plan (RPP) –** Since April 2005, the Ontario Energy Board (OEB) has administered an electricity price plan that provides stable and predictable electricity pricing, encourages conservation and ensures the price consumers pay for electricity better reflects the price paid to generators. This pricing plan is known as the Regulated Price Plan (RPP). About 5 million residential consumers, small businesses and farms are eligible for the RPP.
- **Ontario Power Generation (OPG) –** A business corporation owned by the Province that owns and operates generation assets, including nuclear and hydro, and generates almost half of Ontario’s electricity.
- **Ontario Energy Board (OEB) –** A Crown Agency that independently regulates Ontario’s electricity and natural gas sectors in the public interest. Implements an open and transparent process to allow for stakeholders to participate in quasi-judicial proceedings and formal stakeholder consultations.
- **Independent Electricity System Operator (IESO) –** An independent corporation established under the *Electricity Act, 1998* that operates the electricity market in Ontario. Balances the supply of and demand for electricity in Ontario and then directs its flow across the province’s transmission lines, including interties with other jurisdictions.