Global Adjustment Smoothing

Summary of Key Risks

This note summarizes risks related to the proposal for Global Adjustment (GA) smoothing. Enabling legislation would need to be drafted in a way that minimizes these risks while balancing the objectives of all parties involved.

Accounting (p. 2)	**Opinions on the accounting treatment must be informed by the proposed legislation, which has not yet been drafted. Along with MOF / TBS staff:** • IESO / KPMG are reviewing whether IESO can recognize / derecognize the regulatory asset; and • OPG / EY / PwC are reviewing whether OPG can consolidate the trust / retain GBE status. **Rate-regulated accounting would typically require the OEB to allow an asset to be created.** Options on the potential decision-making role of the OEB are currently being assessed.
Control (p.3)	**To achieve desired accounting treatment, OPG must have decision making authority over, and derive rewards and risks from the trust.** • OPG must agree to smoothing without declaration / resolution from the Province, and have ability to materially affect related decisions. • OPG must also be in a position to earn a return (or face losses) as a result of those decisions. • Despite maintaining sole shareholder powers, these requirements will limit the Province's ability to influence outcomes, and may increase costs.
Legal (p. 3)	**The proposal may be subject to a legal challenge that the regulatory charge is an unauthorized tax on future consumers.** • Based on currently available information, Justice Binnie assesses this risk as moderately high. • The Supreme Court of Canada would be more likely than not to find against constitutional validity, endangering the accounting treatment.
Forecasting (p. 4)	**Overall costs are subject to risk, based on actual costs deferred, market performance, market supply and demand, and borrowing costs.** • As a result, the ability to recover deferred costs, and costs to future consumers, is uncertain. • Due to significant borrowing requirements, costs are highly sensitive to changes in interest rates.

An Overview of the Proposed Structure

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The smoothing proposal is inherently complex, involving several entities in the electricity sector:

- The Independent Electricity System Operator (IESO) would need to be able to establish a regulatory asset, reflecting the deferral / right to recover costs + interest from future ratepayers;
- Ontario Power Generation (OPG), through a trust, would purchase the regulatory asset from IESO in return for payments to IESO in order to fund the upfront shortfall in recovery of GA costs paid by current ratepayers;
- The Province, through ongoing equity infusions to OPG, and outside lenders would provide financing to the trust; and
- The Ontario Energy Board (OEB) may need to oversee the mechanism.

Accounting

- Accounting analysis is not complete, and accounting opinions would require seeing the proposed legislation. Legal counsel has estimated a six week time frame before legislation will be ready, but would include drafting in consultation with OPG, IESO and their external auditors, as well as external law firms, and OPCD and policy staff.
- Targeted accounting treatment requirements:
  - IESO – IESO Finance, KPMG (Energy advisor and IESO auditor), OPCD and EY (OPCD advisor) are evaluating accounting risks:
    - IESO ability to recognize a regulatory asset for the shortfall between the amounts collected from the LDCs and the amounts paid to the PGs using GAAP hierarchy to support regulatory asset under PSAB.
    - IESO ability to derecognize regulatory asset upon sale to OPG.
  - OPG – OPG Finance, EY (OPG auditor), PwC (OPG Advisor), and OPCD are evaluating accounting risks:
    - OPG Trust purchases regulatory asset from IESO – classifies as intangible asset.
    - OPG consolidates Trust.
    - OPG ability to retain GBE status.
- Rate-regulated accounting would typically require an independent regulator, e.g., the OEB, to allow for creating the asset.
  - Options for the role of the OEB is being assessed.
  - OEB involvement may be helpful in providing independent oversight. However, OEB suggests its role should be substantive and meaningful. Given that OEB processes are public and outcomes are uncertain, this may introduce an added layer of risk.
- OPG GBE status is needed as GBE's are consolidated on a "modified equity", one line basis in Public Accounts, reflecting its bottom line (not the individual revenue and expense lines, not debt and liabilities).
- There have been no discussions to-date with the Auditor General. In previous Annual Reports, the OAG has previously raised concerns about recognizing rate regulated assets and liabilities.

Control and Financial Risk Exposure

- Energy's deck reports that OPG must have decision making authority on the operation of the Trust to achieve the targeted accounting treatment. The Trust, operating within the legislation, would be controlled by OPG and able to alter non-legislated terms and conditions to ensure recovery of the deferred amounts. The Trust would be exposed to business risk.
    - It is not clear from the deck what the degree of business risks and losses the Trust might face, and how that works in conjunction with the statement that it must be able to ensure deferred cost recovery.
    - It is not clear how this degree of freedom for the Trust would affect GA amounts to be paid by Regulated Price Plan (RPP) consumers.

Legal Issues

- This proposal would be subject to a constitutional law challenge on the GA regulatory charge as an unauthorized tax on future consumers -- seen as subsidizing near-term consumers at the expense of long-term and future consumers.
    - One of the requirements of a valid regulatory charge (as opposed to a tax) is that the person paying the charge either benefits from the regulatory structure or causes the need for regulation.
    - Energy would need to justify the shift in timing of cost recovery -- reasonably quantifying the rationale that existing contracted assets can and will provide longer-term benefits ten-years beyond their current contract lengths.
    - Were the charge struck down by a court as an unconstitutional tax, consumers would be entitled to recover their payments. This risk could be eliminated, either up front or retroactively, by the imposition of a valid tax.
    - This would endanger the accounting treatment.
- Justice Binnie has reviewed the proposed GA smoothing mechanism. Based on currently available information, he assessed the risk to be moderately high, which means that the outcome of a challenge would be difficult to predict because there are good arguments on both sides, but in the end the Supreme Court of Canada would be more likely than not to find against constitutional validity.
    - However, if the government could demonstrate that benefits and eventual costs of GA smoothing were appropriately allocated to current and future ratepayers, this risk may be evaluated at a lower level.
    - The level of reduction in risk would also depend on the quality of expert evidence that would support the government's position that certain wind, solar and gas facility operations could be extended from 20 to 30 years.

Forecasting (e.g., Cost / Interest Rate) Uncertainty

- The overall cost of a GA option is subject to risk, on actual GA costs to be deferred, which is subject to the contracts and operational and market performance, market supply and demand, and actual borrowing costs.
- The ability to recover the deferred costs, and cost to future consumers, is uncertain, depending on future consumption levels and future market conditions, for example.
- OPG has stated that one condition is for the financing structure for the Trust include a majority of external financing (51% and senior to other debt), and that the other about 49% be supported 5% from OPG financing, and 44% from a Provincial equity injection into OPG (for OPG to then provide financing to the Trust).
    - The availability and cost of external financing is unknown, but would likely be higher than the cost of Provincial borrowing. If the charge to future customers rises above 10% of the total bill, OPG's ability to borrow without a Provincial guarantee becomes challenging.
    - External debt and higher borrowing costs may increase criticism of the structure, as cumulative interest costs could be almost as high as the peak level of debt (which ranges from about $20 billion to $38.5 billion (based on Energy options as at February 23rd)
    - Provincial equity financing for 44% would be financed by Provincial borrowing.
    - OPG would need to earn a return on the equity in order for there to be, on consolidation into Public Accounts, an offset of to the Province's interest on debt costs (net income rising to an annual about $850 million, under the $38.5 billion option, just to cover the assumed interest cost).
- External capital market borrowing by OPG will likely be at a significant higher cost than Provincial borrowing costs.
- External debt may require a Provincial guarantee (limited, say to the case of a legislative amendment on the GA cost deferral and recovery structure. OPG contends that this would not lead to adverse accounting treatment of the OPG Trust being consolidated.
- Annual borrowing could range from $1.4 billion to $3 billion with accumulated debt peaking at $20 billion to $39 billion depending on the scenario chosen.
- It should be noted, that unlike a mortgage where payments from the outset are used to pay for both interest and principal costs, the financing undertaken for GA smoothing would not pay principal amounts for the near longer term, and interest would be capitalized instead.