Ontario's Fair Hydro Plan

Corporate and Electricity Finance Division

DRAFT: June 29, 2017

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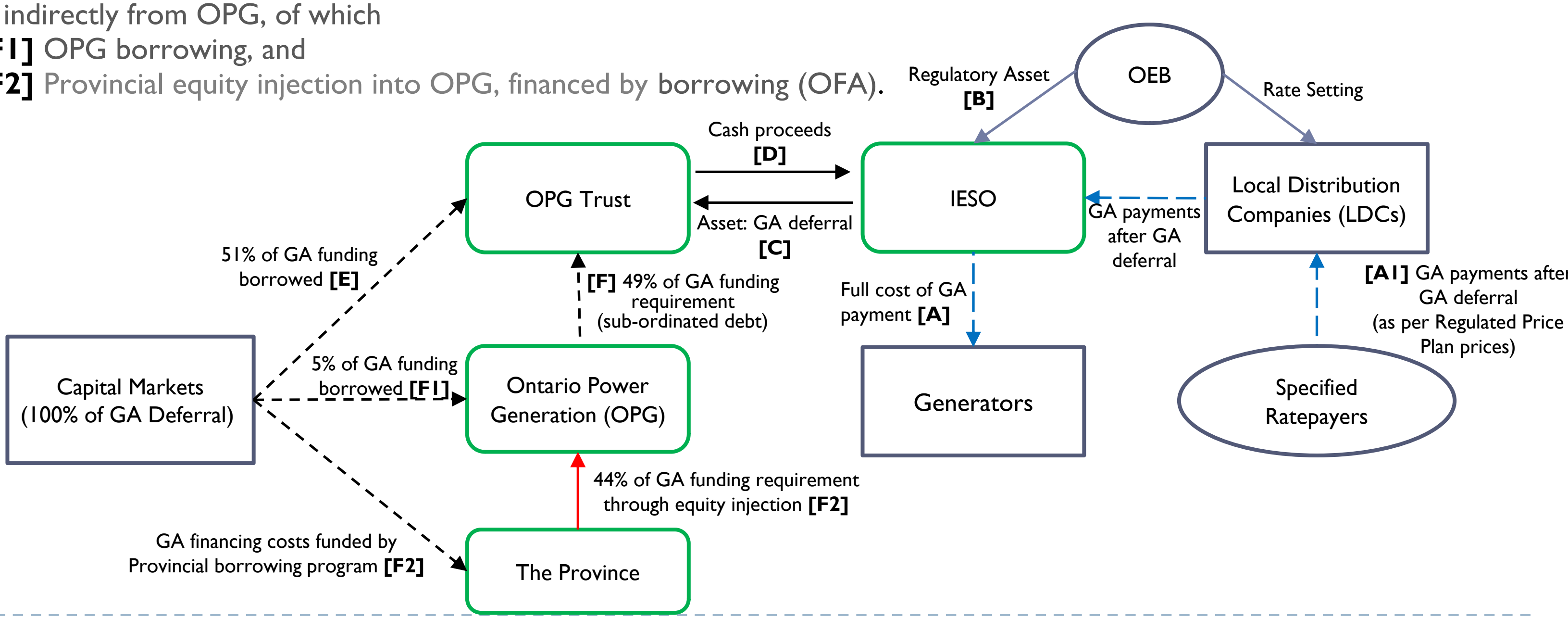
Overview: Ontario’s Fair Hydro Plan

Overview: The Ontario Fair Hydro Plan ("OFHP")

- The Ontario Fair Hydro Plan Act, 2017, enables the implementation of the OFHP, which will lower electricity bills by 25 per cent on average for eligible residential customers. Eligible farms and small businesses will also receive benefits.
  - Implementation steps include regulations under the Act brought forward by the Ministry of Energy for approval.
- The measures that make up the 25 per cent average reduction include
  - Refinancing a portion of the Global Adjustment (GA) to allocate fairly the costs of Ontario's contracts for electricity infrastructure investments over the expected lifecycle of the generation infrastructure assets.
  - The Ontario Rebate for Electricity Consumers, for an amount equal to the provincial portion of the HST, which took effect on January 1, 2017.
  - Shifting funding of the Ontario Electricity Support Program (OESP) and Rural or Remote Rate Protection (RRRP) program from electricity ratepayers to the province.
- People with low incomes, those served by local distribution companies (LDCs) with the highest distribution costs, OESP recipients and On-Reserve First Nation households would benefit from even greater reductions to their electricity bills.

GA Financial Structure

- Through the OFHP, GA costs, including refinancing costs, will be recovered from ratepayers over a longer period of time.
  - The GA refinancing framework will be implemented through the IESO and Ontario Power Generation (OPG).
  - Under the OFHP, OPG establishes a special purpose vehicle financing entities (e.g., OPG Trust) .
- **[A]** IESO continues to pay generators their contracted and regulated prices.
- **[A1]** LDC payments lower, as Regulated Price Plan prices set with a portion of GA deferred to support initial 25% reduction.
- **[B]** IESO sets up a deferral account, a 'regulatory asset', based on a right to recover in the future deferred costs and financing costs.
- **[C]** Under the Act, the IESO would be able to sell the 'right to collect' deferred future revenue from ratepayers to the financing entity in return for cash proceeds **[D]**.
- The funding for the financing entity would be raised from the capital markets:
  - **[E]** directly by the financing entity, and
  - **[F]** indirectly from OPG, of which
    - **[F1]** OPG borrowing, and
    - **[F2]** Provincial equity injection into OPG, financed by borrowing (OFA).



Risks / Cost Sensitivities

Global Adjustment Refinancing Model Assumptions

- Projected Global Adjustment Refinancing costs are affected by actual system costs and consumption, and actual interest rates.
- Variances from these key assumptions could affect actual refinancing costs, etc.

- Interest rates
  - Higher/lower Interest rates would lead to higher/lower refinancing costs
  - For example, a 1.5 percentage point lower interest rate assumption, compared to an illustrative 5% case used by the Ministry of Energy, would halve estimated cumulative interest costs, from about $21 bn to $11 bn.

- Electricity demand
  - Lower/higher electricity demand due to fewer consumers or lower/higher consumption among some consumers would increase/decrease Clean Energy Adjustment costs for remaining consumers.

- System Costs
  - Ministry of Energy is developing the updated Long-term Energy Plan (LTEP), expected to be released in about summer 2017. The LTEP is expected to include measures to continue to reduce system costs.
  - Actual system costs are expected to also be affected by other factors, such as the Ontario Energy Board rate application process.

MOF-Related Outstanding Issues

Provincial Support Agreement
[Ministers' Approval Item: Pending]

- The OFHP Act, s. 5, outlines certain protections and assurances to be provided by the Province, including agreements to be entered into by the Ministers of Energy and Finance with persons under the Act. These include
  - guarantees of, or undertakings by the Province to provide assurances to those with claims against the Financing Entity (with respect to debts, obligations, securities or undertakings associated with an investment interest), and to support credit ratings, and to outline undertakings by the Financing Entity and possibly the Province for satisfying funding obligations.
- A proposed Provincial Support Agreement is currently under discussion among Ministry of Energy, Ministry of Finance, OFA, external legal consultants and OPG.

Target Timing: End of July

Provincial Support Agreement (cont.)
[Ministers' Approval Item: Pending]

- The Province and OPG are working on a Provincial Support Agreement – a work-in-progress.
- There are three facets of a current draft proposed Provincial Support Agreement. Each of these would require Agreement/approval of Ministers of Energy and Finance:
  1. Service Guarantee: Province to guarantee the performance of the IESO and electricity vendors under the Act including billing, collection and remittance of clean energy adjustments.
  2. Indemnity: Provided by Province for Financing Entity against third party claims as a result of government amending or repealing the Act or court rulings adversely affecting the rights and interest of the Financing Entity. Indemnity applies only to direct government actions and would not cover, for instance, OPG activities
  3. Avoidance of Mismatches: during a reference period, between Financing Entity funding obligations and amount available from investment interests: Outlines roles and expectations of Financing Entity to make efforts to arrange for commitments from market-based funding sources and, if unable to do so, possible Province funding commitments under terms and conditions, including appropriate compensation to the Province.
  - Under both the draft Service Guarantee and the Indemnity, the Service Guarantor (the Province) would have the option to satisfy obligations by "stepping in" and paying, when due, regularly scheduled amounts.
  - In both cases the Servicing Guarantor would not be obligated under any circumstances to pay consequential, special or punitive damages, or for economic loss or loss of profits.
- Note: Separation between the Province and OPG is necessary to maintain appropriate accounting treatment.

Indemnities Requested by OPG & IESO
(For Minister's s.28 Approval)

- The Ministry of Energy is proposing to provide, on behalf of the Province, certain indemnities as requested by OPG and IESO, and is asking, pursuant to Section 28 of the *Financial Administration Act* (FAA), that the Minister of Finance approve this request.
  - OPG and IESO are requesting that the Province indemnify the corporations (OPG and subsidiaries, not including a financing entity, and IESO), respective directors, officers and employees with respect to their roles in implementing the Ontario Fair Hydro Plan (OHFP).
    - A protected person would not be entitled to be indemnified in respect of losses for which coverage is provided elsewhere, including through insurance policies or existing statutory indemnities.
    - Indemnity would not cover a protected person losses that are the result of such protected person's dishonesty, gross negligence or willful misconduct.
- In implementing the OFHP, OPG and the IESO expect to carry out activities that fall outside the scope of their pre-OFHP business activities and corporate mandate. They believe this could subject them to the risk of claims that they are not acting in the best interest of the corporation or in "good faith" with respect to their obligations to their respective corporations.
- The Indemnity Agreements extend to the OPG and the IESO as corporations, beyond the more normal practice of indemnifying directors, officers and employees; and also extends to subsidiaries of the OPG, excluding financing entities under the OFHP Act.
- The Indemnity Agreements include a waiver of claims with respect to indemnitees who are individuals by the Province as shareholder, meaning that except for gross negligence, dishonesty and wilful misconduct, the Province cannot bring an action against an indemnified individual.
- Ministry of Energy notes that in the event that an indemnity claim does arise and a payment is required, the Ministry would be unlikely to be able to support these payments from a current allocation and would need to return to TB/MBC for an adjustment to its allocations.

Indemnity (cont'd)

(For Minister's s.28 Approval)

- Ministry of Finance staff recommend approval of the s.28 request.
  - Ministry of Energy indicates that the Indemnities have been requested by the companies, supporting the implementation of the OFHP.
  - Both the IESO and OPG have specifically asked for these Indemnities in order to allow them to carry out their roles in implementing the ONFHP
  - The Ministry of Energy states that the risk of the Province providing the Indemnities is undeterminable at this time, due to uncertainty around possible claims under the Indemnities. Ministry of Energy notes, however, that the risk is mitigated by the existence of statutory immunities under the *Electricity Act, 1998,* for IESO, and under the *OFHP Act, for OPG,* pre-existing protection for director, officers and employees under insurance and, the limitation of indemnity to claims arising from IESO's and OPG's respective roles in implementing the OFHP.

Target Timing: End of June

IESO Treasury Policy
(For Minister's Approval)

- As prescribed under Regulation 280/14 under the *Electricity Act, 1998,* the IESO is required to maintain investment, borrowing and financial management policies and procedures.

- As required under the Regulation, the IESO has submitted a revised IESO Treasury Policy for Minister of Finance approval.

- The revised IESO Treasury Policy incorporates the following two changes:
  1. Permit borrowings to ensure funding of any amounts resulting from or required under the *Ontario Fair Hydro Plan Act, 2017.*
  2. Increase counterparty exposure to Schedule A Canadian Banks from the current $420million to $500 million, an increase of $80 million exposure per counterparty.
     - This ensures that the IESO has flexibility to efficiently manage its cash accounts as evolving business requires IESO to manage higher cash flows and seek appropriate short-term investments.

- OFA staff have reviewed and have no concerns with the requested changes.

<u>Target Timing</u>: <u>End of June</u>

Equity Injection – Key Proposed Terms

OFA to Support under a Service Level Agreement

The terms for the Equity Injection are set out in the Fair Hydro Plan – Master Subscription Agreement Term Sheet.

- The Province agrees to inject (monthly, as required) 44% of total funding of GA asset by way of equity subscription in OPG, which amount OPG in turn will invest in the Fair Hydro Trust as subordinated debt (**Equity Injection Plan**)
- Ministry of Energy (as Shareholder) will seek appropriation on an annual basis through PRRT.
- OPG agrees to use the equity subscription amounts solely for funding the Fair Hydro Trust's subordinated debt requirements as part of the Fair Hydro Plan
- OPG will amend articles of incorporation to create an additional class of shares – Class A Shares – which will be non-voting and redeemable at OPG's option.
- Ministry of Energy and OFA would, as proposed, have a service level agreement in place providing authority for OFA to provide cash management services to facilitate share purchases on an ongoing basis on behalf of the Ministry of Energy, subject to the approved PRRT amount and 44% share.

Target Timing: **End of July**

Equity Injection:
Subordinated Debt from OPG

- OPG will lend 49% of the GA asset to the Fair Hydro Trust as subordinated debt
  - OPG will use the Province's Equity injection of 44% of the GA asset
  - OPG will issue to investors an amount equal to 5% of the GA asset
- There will be one or more mezzanine levels of subordinated debt
  - Each mezzanine level of debt will have a different spread over Government of Canada bonds
- The Province's fiscal impact is expected to be minimized
  - Province will have an increase in interest expense arising from issuing long-term debt to finance the equity injection
  - OPG will have increased income from the subordinated debt interest
- The OFA is currently reviewing OPG's subordinated debt interest proposal and will provide comments to OPG once more discussions have taken place with Ministry of Energy staff

Target Timing: End of July (TBC)

Performance Management Fees

- OPG will be providing all required services to the Trust as part of the OFHP, including planning, strategy, financing, deal execution etc.

- The legislation (s. 19.3) allows OPG to establish and charge a management fee for those services in accordance with the regulations, which are currently in development.

- There are two components to the model proposed by OPG:
  - Base fee: the structure will allow OPG to earn a commercial fee, an accounting consolidation requirement, with periodic OEB review of the commercial basis of that fee. OEB and OPG are in discussions in order to develop a model that satisfies the accounting requirements and is consistent with OEB's processes.
  - Performance management fee: OPG has the ability to gain or lose depending on the actual financing cost relative to a benchmark, which would be shared equally between ratepayers and OPG. Gain/loss is capped (TBD).

Payment in Lieu of Taxes Exemption
(Minister's Approval Item: Minister's Reg.)

- Request from OPG – and supported by ENERGY is a PILs exemption for the income arising from the OPG financing vehicle/OPG as a consequence of the Fair Hydro Plan.
  - With no PILs exemption, ratepayers will bear the cost of PILs through the rate base.
  - OPG has sought a broad comprehensive PILs exemption for a variety of potential financing structures including corporations, trusts or partnerships.

- The PILs regulations under the Electricity Act are under the purview of the Minister of Finance.

- TPD recommends [TBC] a regulatory exemption for each specific financing entity structure, once the structure is determined. A blanket exemption would create significant risks to provincial revenue and require a number of complex conditions to minimize the potential for precedents and tax avoidance.

- TPD proposes bringing forward for approval the required regulation(s) once OPG advises on each specific financing entity structure and any anticipated future structures or changes to the structure.
  - OPG has raised questions on the timeliness of response for a new regulation, as OPG special purpose vehicles for financing may be put together quickly to respond to different markets and market conditions

Target Timing: By August/September

Appendix: OFHP Additional Measures / GA Financial Flows & MOF / OFA Roles

The Ontario Fair Hydro Plan: Additional Measures

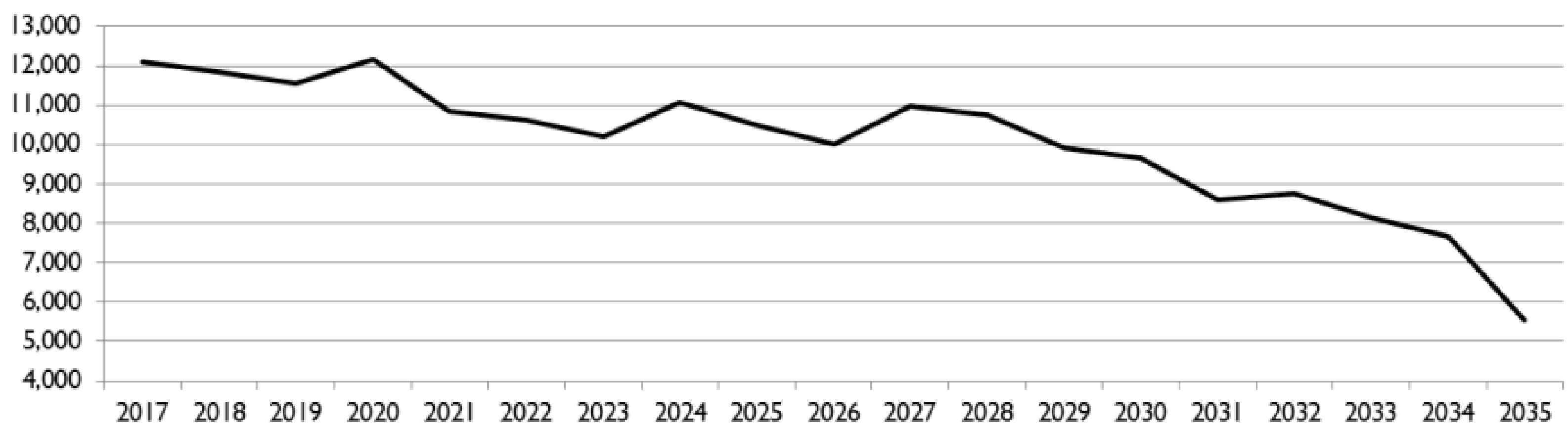
- In addition to the 25% bill reduction, on average, for residential customers, other measures that make up the Fair Hydro Plan include
  - Expanding the Industrial Conservation Initiative (ICI) to include electricity consumers, in the manufacturing and certain other sectors including greenhouses, with an average monthly peak demand of greater than 500 kW and less than 1 MW.
  - Expanding the OESP, by providing 50 per cent more support in the form of monthly credits for people with low incomes and increasing eligibility, effective May 1, 2017.
  - Establishing an Affordability Fund that will be accessible to LDCs for customers who do not qualify for low -income conservation programs and who are unable to undertake energy efficiency improvements without financial assistance.
  - Providing on-reserve First Nations households with a 100 per cent credit of the delivery line on their monthly electricity bills.
  - Enhancing the Rural or Remote Rate Protection (RRRP) program to provide distribution charge relief to about 800,000 customers and shift costs from ratepayers to provincial revenues. This would include customers served by local distribution companies (LDCs) with the highest rates.
  - Improving energy sector efficiency and modernize the province's electricity market, building on the collaboration of the Independent Electricity System Operator (IESO) and the Ontario Energy Board (OEB).
- The government-funded measures (OESP, RRRP, on-reserve credits and the Affordability Fund) have been communicated to cost the government about $2.5 billion in the first three years (and would have an on-going annual cost to government). (Note: Actual amounts in the 2017 Budget fiscal plan is a little less, due to partial year implementation in 2017-18).

Refinancing the Global Adjustment

- Refinancing the Global Adjustment (GA) provides significant and immediate rate relief by spreading the cost of electricity investments over a longer period of time.
- Under forecasts provided by the Ministry of Energy at the time of the OFHP announcement in March, the immediate reduction (i.e., the financed portion) in the GA would be about $2.5 billion per year on average over the first ten years.
- This measure would share the associated costs more fairly. The illustrative chart below shows how Global Adjustment (GA) cost is front-end loaded and forecast to decline over time.

NOTE: Energy and IESO forecasts are subject to update, including as part of the Ministry of Energy's current Long-term Energy Plan update process.

Forecast Global Adjustment Cost (nominal $ million)



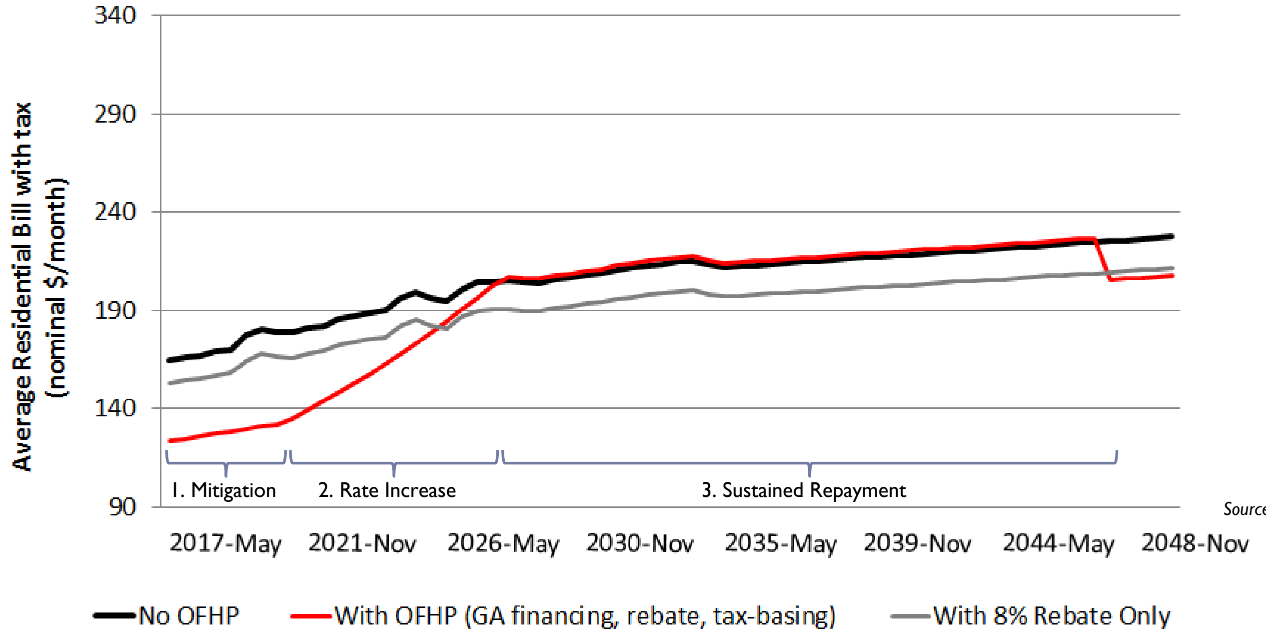
Source: IESO

Global Adjustment Financing: Policy Rationale

- The purpose of the Global Adjustment refinancing is to
  - Ensure that clean energy costs and clean energy benefits are fairly allocated among present and future specified consumers
  - Recognize that clean energy benefits have accrued and will accrue over time and will continue to benefit present and future electricity consumers in the Province, and
  - Align clean energy costs with clean energy benefits, in order to provide fairness for specified consumers over time.
- The majority of the province's electricity generators are under 20-year contracts. Many of these generators will be able to operate past their contract term.
- By recognizing that generation assets are expected to continue to provide benefit to future ratepayers, beyond the term of current contracts, future ratepayers are expected to be able to utilize these assets and reduce the need to finance the development of new generation assets.
- In the early years, a portion of the costs covered by the GA would be financed to reduce pressure on electricity ratepayers.
- In the later years, when some system costs are expected to be reduced due to continued operation of existing assets under 20-year contracts, the deferred amounts and cost of financing would be recovered from ratepayers through a "Clean Energy Adjustment".

Global Adjustment Financing

- GA Financing structure and bill impacts can be thought of as having three phases (see illustrative chart below)



Source: Ministry of Energy

Phase 1: Mitigation

- 2017 residential bill 25% on average lower than original projection (pre-8% Ontario Rebate for Electricity Consumers).
- Increase in bill capped to 2% per year until 2021.

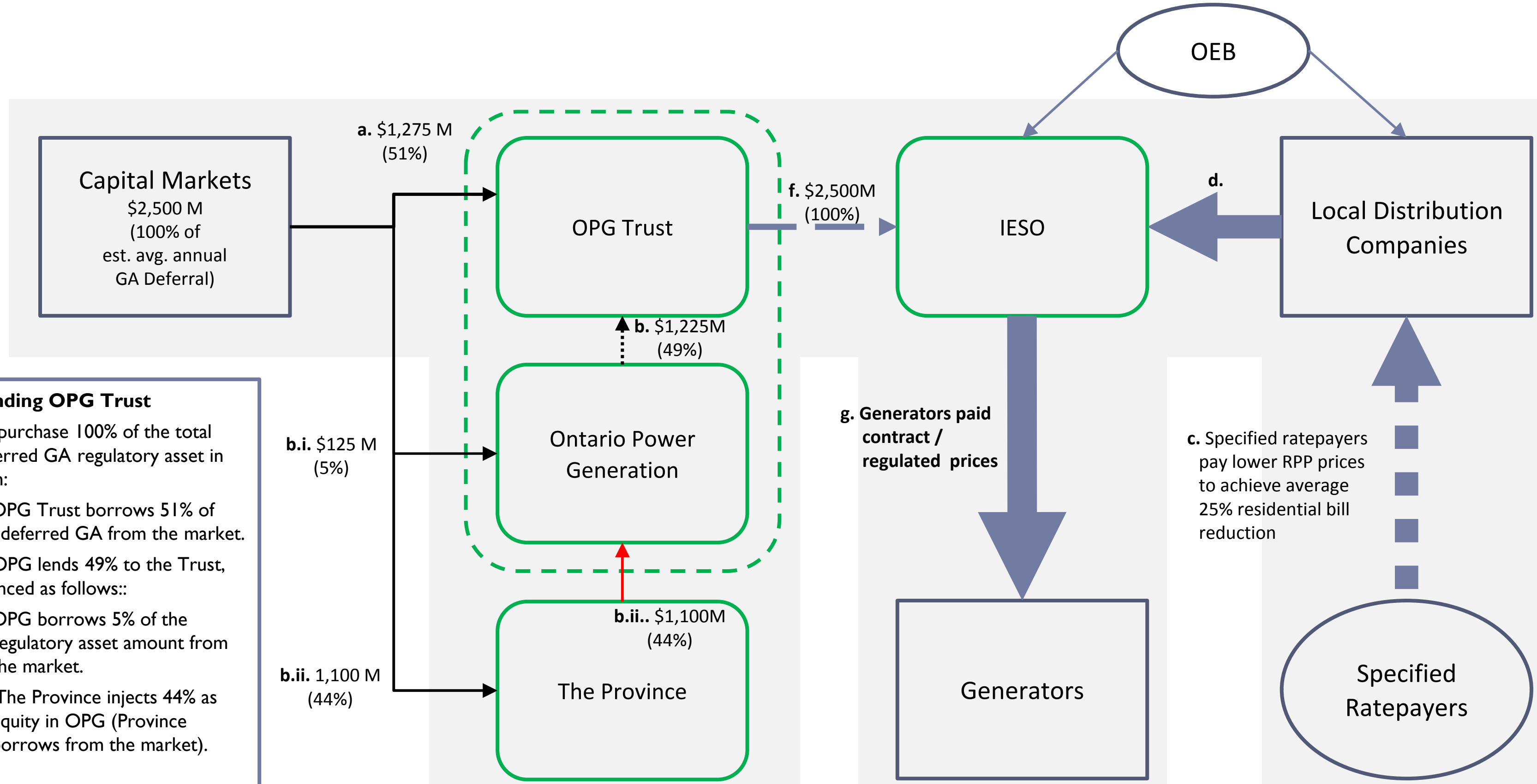
Phase 2: Rate Increase

- Residential bills continue lower than without the OFHP; however, not by 25% on average.
- Bill increases each year, limiting overall deferral and borrowing.
- Planned increases for the above purpose projected to end in 2028 when sustained repayment starts.

Phase 3: Sustained Repayment

- Bill higher than projection, excluding the GA deferral, until 2047 (estimated).
- Difference between with OFHP (red) and 8% rebate (grey) only represents recovery of deferred GA and financing.

GA Financing Structure: Illustrative Fund Flows* - Mitigation Phase



Funding OPG Trust

To purchase 100% of the total deferred GA regulatory asset in cash:

a. OPG Trust borrows 51% of the deferred GA from the market.

b. OPG lends 49% to the Trust, financed as follows::

- i. OPG borrows 5% of the regulatory asset amount from the market.
- ii. The Province injects 44% as equity in OPG (Province borrows from the market).

Deferral Mechanism

c. Specified ratepayers pay RPP prices, including the non-deferred portion of the GA to LDCs.

d. The LDCs remit this amount to the IESO ...

e. …The IESO recognizes a regulatory asset – the right to collect the deferred amount, and a financing cost, from ratepayers in the future.

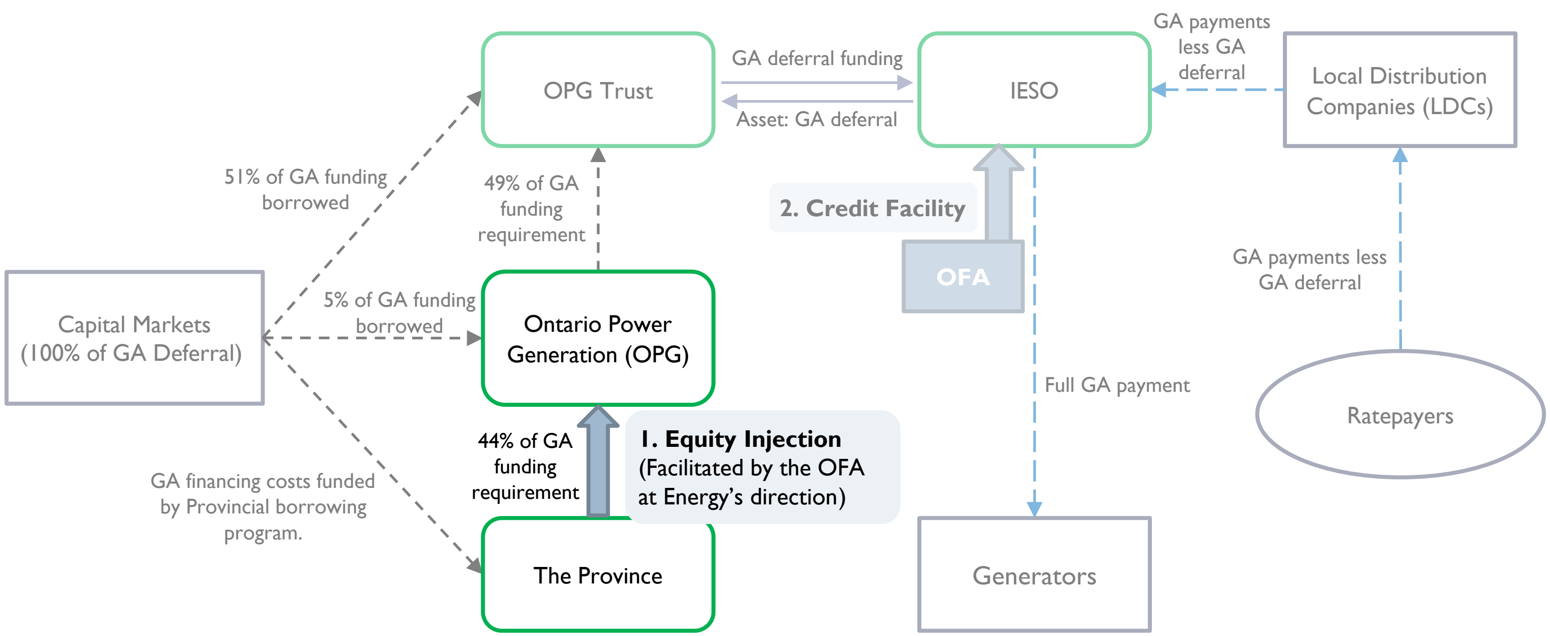
f. IESO sells this asset for cash to OPG Trust.

g. IESO uses the proceeds from the sale of the regulatory asset and the collection amount from LDCs to pay the full amount of the GA cost to Generators (and conservation costs).

* Amounts are illustrative and based on an assumed deferred cost, or regulatory of $2.5 billion.

Equity Injection

- The 2017 Budget includes in the Ministry of Energy Estimates an investment operating asset of $1.1 bn related to the Province's equity injection to OPG. OPG would provide financing to the Trust through sub-ordinated debt, as part of the OPG Trust financing to regularly purchase IESO's regulatory asset through 2017-18.
- The structure would
  - increase gross debt of the Province (to finance the equity injection in OPG),
  - increase net investment in OPG (so no net debt impact),
  - increase interest on debt related to that external debt, which
  - on consolidation into Public Accounts, would be offset by increased earnings of OPG from sub-debt interest revenue.



GA Financing: Illustrative Net Debt Impacts

Province of Ontario - Consolidated Statement of Financial Position

As at March 31, 2016 ($ Millions)		**GA Financing Impacts Est. Average Annual**	
Liabilities			
Accounts Payable and Accrued Liabilities (Schedule 5)	19,361		
Debt (Note 2)	327,413	**1,100**	⬆
Other Long-Term Financing (Note 4)	14,145		
Deferred Revenue and Capital Contributions (Note 5)	10,779		
Pensions and Other Employee Future Benefits (Note 6)	12,107		
Other Liabilities (Note 7)	4,905		
	388,710		
Financial Assets			
Cash and Cash Equivalents	13,600		
Investments (Note 8)	21,765		
Accounts Receivable (Schedule 6)	11,059		
Loans Receivable (Schedule 7)	11,545		
Other Assets	1,936		
Investment in Government Business Enterprises (Schedule 9)	23,572	**1,100**	⬆
	83,477		
Net Debt	(305,233)	**0**	—
Non-Financial Assets			
Tangible Capital Assets (Note 9)	102,536		
Accumulated Deficit	(202,697)		

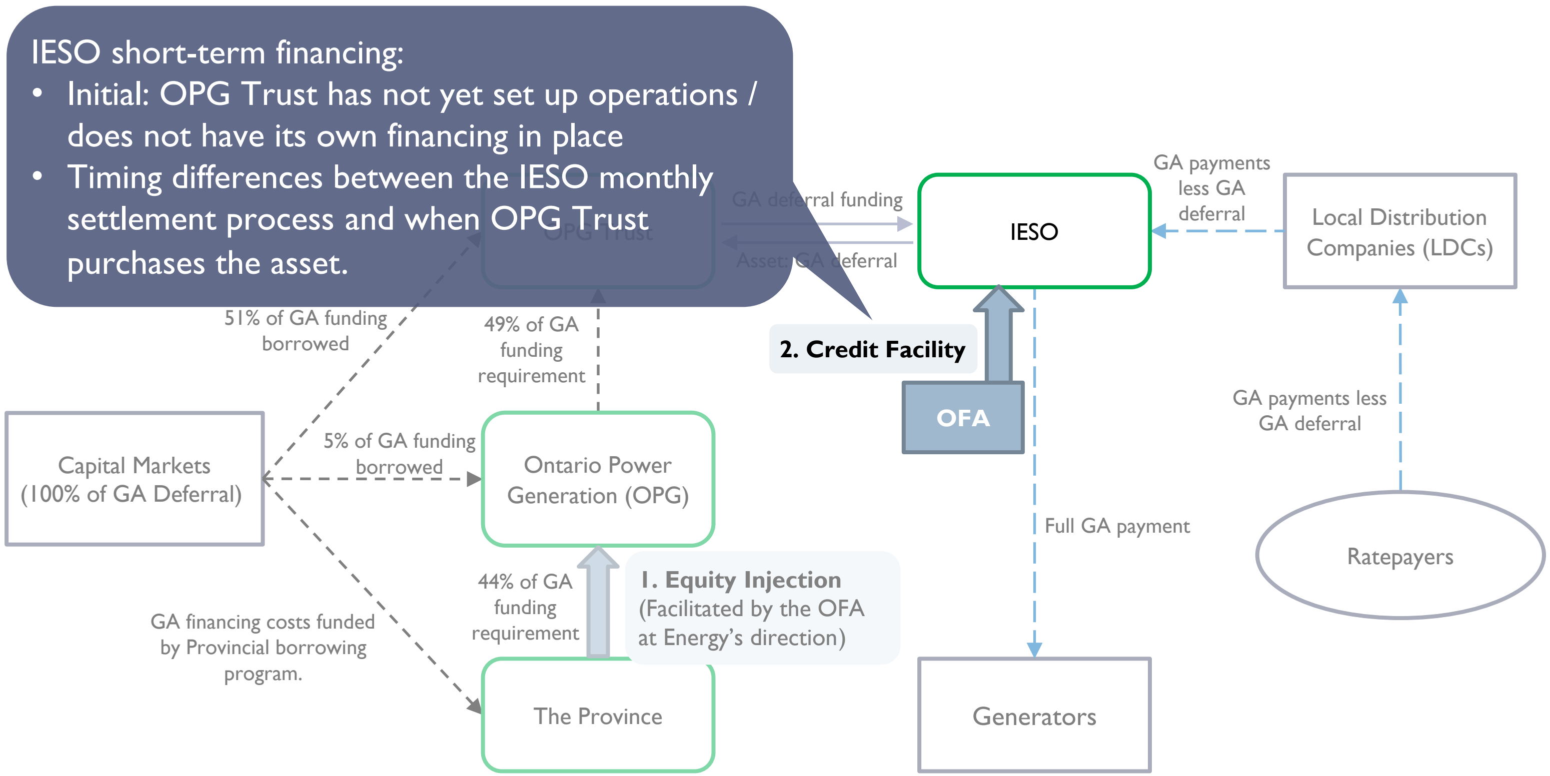
- Increased borrowing required to fund equity injections.
- Provincial debt will increase.

- Equity injections increase investment in OPG

- Offsetting impacts lead to zero net debt impact

OFA/IESO Credit Facility

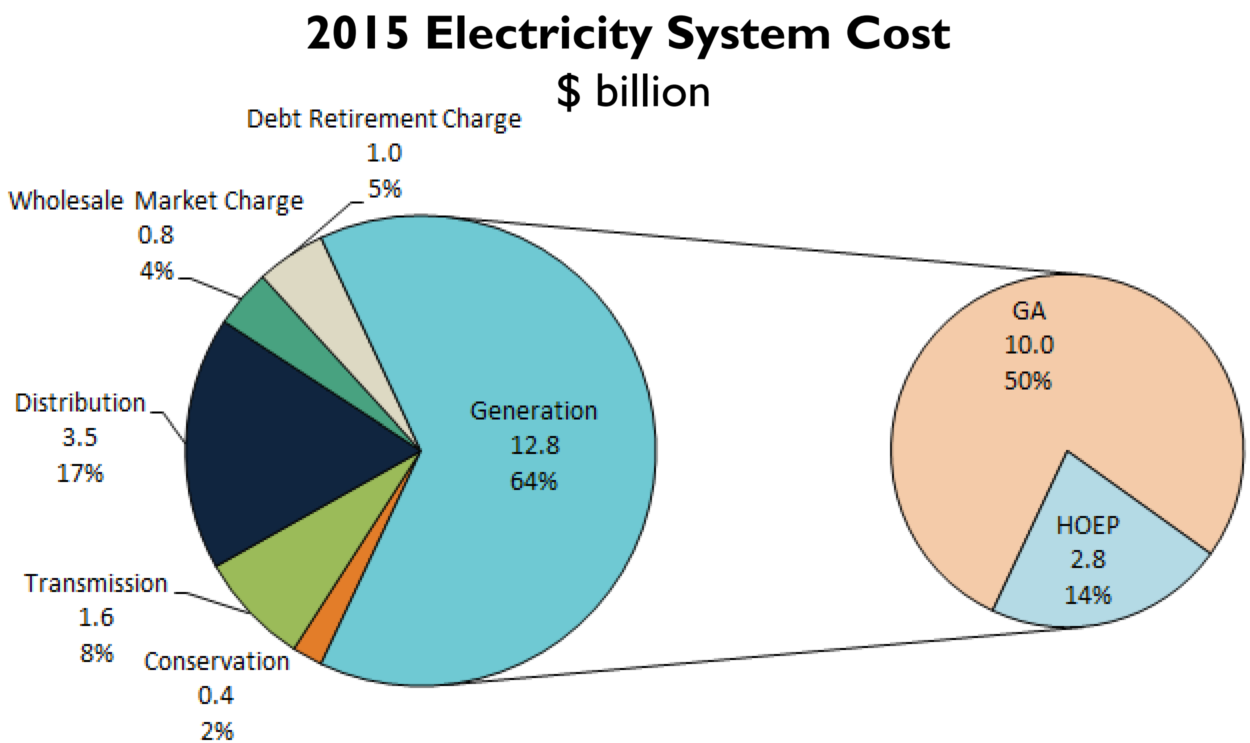
- The Fair Hydro Act, 2017 provides for the IESO to sell the right to recover those deferred amounts of the global adjustment from specified consumers in the future (the "regulatory asset").
- It is anticipated that the regulatory asset would be purchased by the financing entity to be established by OPG ("OPG Trust"). The cash received would be used by the IESO to fund the current Global Adjustment deferral shortfall.



Appendix: Background

Context: Ontario's Electricity Market

- In 2015, generation accounted for 64% of total electricity system costs. Total system costs in 2015 were $20 billion.



DEFINITIONS:

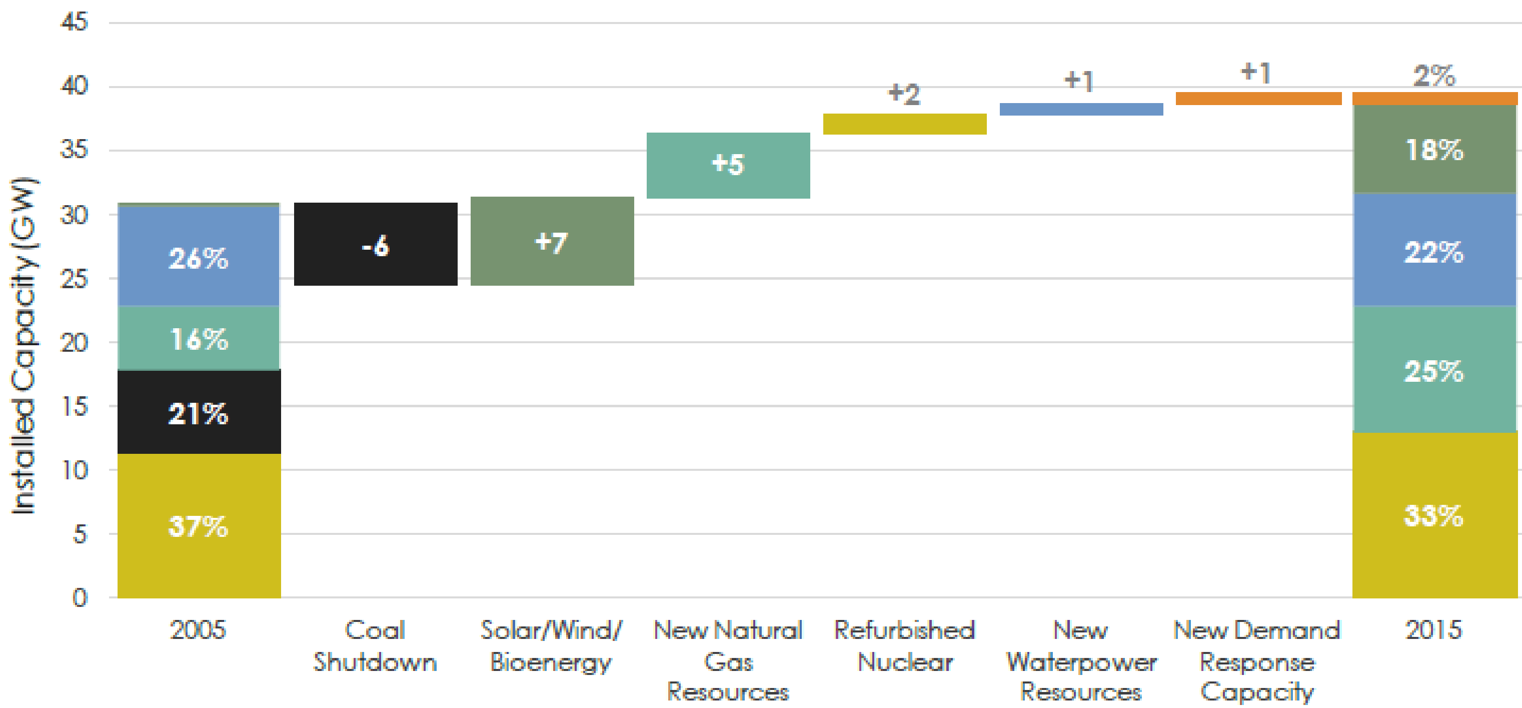
GA: The "Global Adjustment" accounts for differences between the market price of electricity and the rates paid to regulated and contracted generators and for conservations programs. The GA is collected from all electricity rates payers in Ontario

HOEP: Hourly Ontario Electricity Price.

Source: IESO

Context: Significant Change in Supply Mix

- **Between 2005 and 2015, government invested more than $50 billion in the electricity system, including $35 billion in electricity generation to restore reliability, replace coal and meet environmental objectives.**
  - Electricity costs are increasing as necessary investments are made to decarbonize and modernize the province's electricity infrastructure.

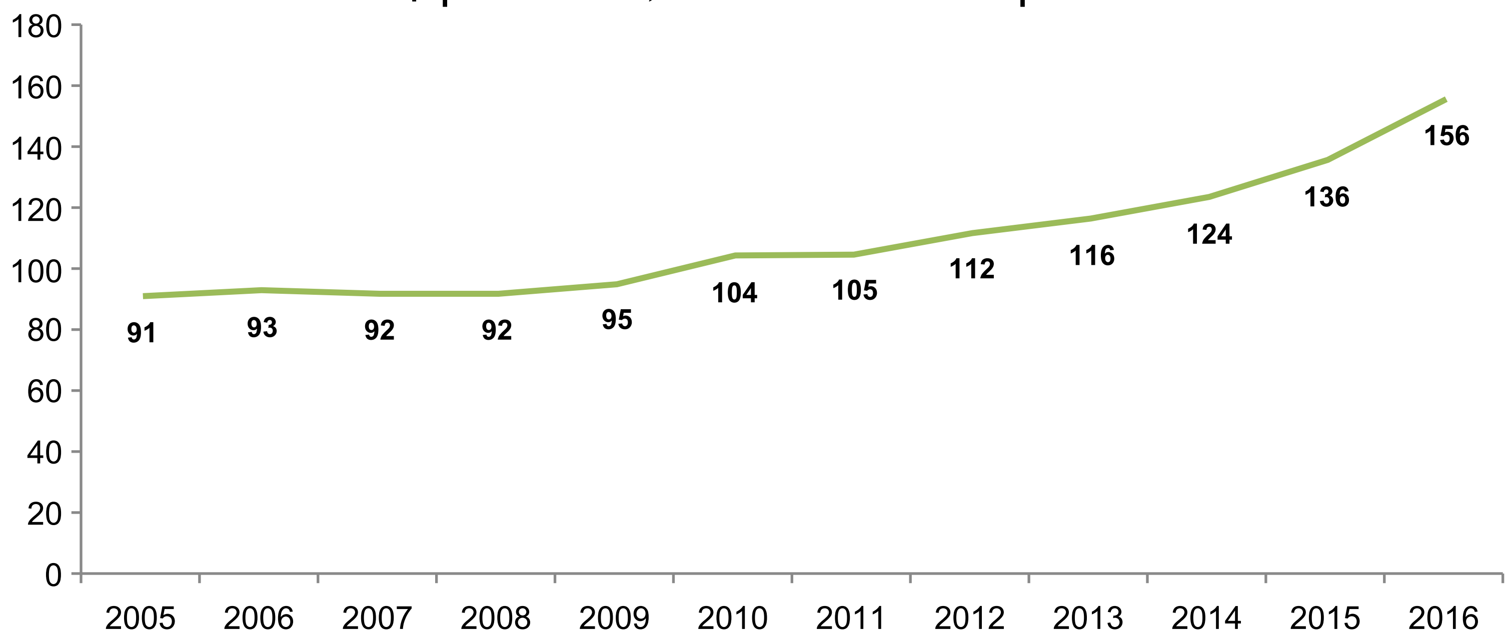


Source: IESO

Context: Electricity Prices Have Increased

- Since 2010, electricity prices have increased at a rate higher than the Consumer Price Index (CPI).

Typical Residential Electricity Bills
in $ per month, 750 kWh consumption



Source: Ministry of Energy