TBS

Briefing Note

Office of the Treasury Board
Office of the Provincial Controller Division
Program Expenditure Management Division

Debt Financing the Global Adjustment: Preliminary Accounting and Fiscal Analysis

Issue:

The Ministry of Energy is exploring an electricity rate mitigation option in which the billing impact of the Global Adjustment (GA) on ratepayers would be reprofiled to be lower in the immediate term and spread out over a longer timeframe. The incremental cost of the initiative associated with debt financing would be borne through future rates.

Current Status:

The Ministry of Energy has requested comments from the Ministry of Finance and Treasury Board Secretariat.

Background:

The Ministry is implementing a series of electricity price mitigation initiatives, such as the Ontario Rebate for Electricity Consumers (OREC provides a rebate of 8% of electricity bills) that launched January 1, 2017. OREC is currently funded from taxpayers. The Ministry is also developing further electricity rate mitigation initiatives that utilize cap and trade proceeds, including rate relief for industrial and commercial consumers. In addition, MOECC's Climate Change Agency is expected to develop further programs that could provide rate relief.

Global Adjustment (GA) is comprised of several elements. A key GA charge is to electricity consumers to make up the gap between the market price of electricity and the higher, non-market prices that most electricity producers, both public and private producers, receive through contract prices. For residential customers, GA is embedded within time of use rates as a cost per kilowatt hour. For major manufacturers and large businesses, the fee appears separately on electricity bills.

The current proposal is that debt would be issued to finance IESO's costs resulting from the timing gaps between producer/program expenses and proceeds collected from energy consumers through the GA. It is not clear which entity (the Province or IESO or some other entity) would issue the debt, and therefore whether IESO would receive proceeds, and if so, how that would be recorded.

Energy's proposal includes scenarios that set the 2017 amount of GA paid by ratepayers at a value lower than the true cost of GA and increasing that amount year-over-year at inflation (assumed to be 2%) until the debt has been paid off.

The proposal would have impacts on the Province's consolidated debt position and Interest On Debt, in addition to any fiscal impacts that would arise through consolidation of IESO.

The assumptions and numbers in the proposal would need further review. The Ministry of Energy notes a number of impacts on ratepayers. It is unclear whether these could result in further pressure on government to offset these. These include:

- Incurring debt to finance the GA, while lowering costs in the short term, results in a more rapid rise in electricity prices beyond the rate of increase already expected.
- The GA financing proposal involves accruing large amounts of debt to reduce electricity rates. This debt would be highly sensitive to interest rates which could extend repayment timelines or put significant pressure on rates (see Scenario 3 for an example of such interest rate risk).
- GA and HOEP provide a natural hedge against each other. Smoothing only one component would lead to greater price volatility. For example, if HOEP is higher than expected (due to higher gas or carbon prices, for example), all-in rates will rise significantly as the natural decrease in GA would not occur given the prescribed GA rate.
- Conversely, if GA is higher than forecast (i.e., because of lower HOEP or additional out-of-market costs), the debt would increase to a higher amount, requiring additional debt service payments and/or a longer recovery period.
- Should Ontario demand be lower than forecasted, the cost of paying off the debt will be shared by a smaller pool of consumption, further increasing future costs for individual ratepayers.

<u>Accounting Treatment and Risks</u>

OPG is subject to the Ontario Energy Board's approval for its rate proposals, including what costs can be included as recoverable. The Global Adjustment is accounted for by the IESO similarly to a rate regulated asset/liability. If the OEB were to agree that the proposal would not change the nature of the accounting for the Global Adjustment, then OPG could receive approval for rates calculated on that basis of recoveries. Costs and revenues will then follow the pattern presented in the proposal.

It is not clear, however, how the IESO would account for the cost gap that would be debt-financed. The proposal appears to suggest that the government could legislate an obligation to pay, which would have the effect of creating an accounting asset. [PLACEHOLDER]

The impacts on the Province's consolidated financial position and on IESO's financial position would be reviewed by the Ontario Auditor General, as well as the presentation. It is not known whether the AG may argue that the reprofiled costs are not fairly reflected on the IESO's and the Province's financial statements due to the accounting treatment. The IESO should be asked to provide an assessment of potential accounting risks associated with this proposal (based on discussion with their external auditors) to help inform the Province's accounting treatment for the consolidated financial statements.

In addition, even if IESO's auditors agree that the reprofiled costs can be reflected in accordance with MOE's proposal, the AG may insist that the costs be accounted for differently based on her current non-supportive position on rate regulated accounting.

There is also a risk that the Auditor General may comment on the proposal from a value-for-money basis, including the issue that the significant deferral of electricity system costs over a long time-horizon and associated interest costs may appear to create new "stranded debt" of the sector. This could be seen to challenge the government's taking credit for the end of the Debt Retirement Charge. It also raises questions of intergenerational equity, in that future ratepayers would be charged generation costs of electricity they did not consume; this would require constitutional law analysis for the risk of a Eurig challenge.

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