Re: Call with OPG

From: Gadi Mayman <gadi.mayman@ofina.on.ca>
To: "Nelms, Scott (ENERGY)" <scott.nelms@ontario.ca>
Cc: "Kandeepan, Ken (OFA)" <ken.kandeepan@ofina.on.ca>, "Kwan, Ronald (OFA)" <ronald.kwan@ofina.on.ca>, "Thompson, Scott (MOF)" <scott.thompson@ontario.ca>, "McLean, David (MOF)" <david.mclean@ontario.ca>, "Wynberg, Lynsey (OFA)" <lynsey.wynberg@ofina.on.ca>, "Kennedy, Nancy (MOF)" <nancy.kennedy@ontario.ca>
Date: Wed, 15 Feb 2017 23:44:12 -0500

It's an interesting construct. I assume in this structure that the loan from OPG to the Trust has to be subordinated to the 3rd party loans, because if they rank equal to each other, or pari-passu to use the legal term, wouldn't the third party lenders have to be totally reliant on the legislation to ensure that they'd be fully repaid, rather than relying on OPG taking the first 49 per cent of the loss?

Subordinated loans usually carry a higher interest rate than those that are more senior to them, but to make the model work as it's currently structured, the interest rate cap on the total amount borrowed is 5 per cent. If interest rates rise, or the third party lenders require a larger spread, and the third party loans are at a rate higher than 5 per cent, the interest rate on the loan from OPG would have to be lower than that of the third party. This might raise eyebrows, and, more importantly, might have OPG's auditors demanding a write down of the amount of the present value of the implicit subsidy of the interest rate on the loan, wouldn't it?

> On Feb 15, 2017, at 10:50 PM, Nelms, Scott (ENERGY) <Scott.Nelms@ontario.ca> wrote:
>
> Hi,
>
> I circled back with OPG for clarity. Here is the latest on the model, as explained to me:
>
> - province provides 49 percent equity infusion to OPG (current OPG)
> - OPG lends to Trust at 5 percent
> - this enables OPG trust to borrow remaining amount from external sources
> - OPG Trust recovers principle and interest sufficient to cover OPG and 3rd party loans, from ratepayers per schedule
> - OPG Trust repays OPG and OPG books interest revenue which is consolidated to the Province, offsetting incremental IOD costs (with some potential timing impacts)
>
> Details are still being worked through, but this appears to be the concept.
>
> Scott
>
> Sent from my BlackBerry 10 smartphone on the Rogers network.
> Original Message
> From: Ken Kandeepan
> Sent: Wednesday, February 15, 2017 10:26 PM
> To: Kwan, Ronald (OFA)
> Cc: Mayman, Gadi (OFA); Nelms, Scott (ENERGY); Thompson, Scott (MOF); McLean, David (MOF); Wynberg, Lynsey (OFA); Kennedy, Nancy (MOF)
> Subject: Re: Call with OPG
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>
> On your last point, not really. If the province borrows and used the proceeds to make a loan the interest rate on the loan should be equal or greater than its cost of debt. Otherwise as you point out an upfront loss is triggered.
>
> My understanding of the accounting rules is that such is not the case for an equity injection where the expected return, if any, need not be directly linked to the cost of the Province's debt.
>

> Having said it goes back to Gadi's point that OPG provides the province with an ROE which is either recovered from the ratepayers each year hence reducing the GA smoothing benefit or recovered later. In other words ratepayer pays now or later.
>
> Of course if no ROE then the Province bears the fiscal burden of the interest for the debt to fund the equity injunction.
>
> Thanks
>
> Ken k
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>
>
> Thanks
>
> Ken
>
>> On Feb 15, 2017, at 9:43 PM, Ronald Kwan <Ronald.Kwan@ofina.on.ca> wrote:
>>
>> Hi Gadi,
>>
>> I agree on all that. The more complicated the structure, the harder it will be to explain and the more subject to complaints and misinformation, innocent or not.
>>
>> Technically, on the government's equity, covering its debt cost to finance the equity makes perfect sense. That said, there are still people asking why the rate regulated OPG ROE can't be zero, forgetting that the Province still has to service the debt it took on to acquire the equity.
>>
>> The GA situation will be that much worse to explain.
>>
>> And, as you note, the third party debt cost would be even harder to explain, and some ratepayers might say they'd rather pay now than pay later with interest.
>>
>> You raise the notion of the Province offsetting the external debt cost with a lower cost of equity on its 49%. That would be a very hard one to explain, and I think there'd have to be an accounting analysis on that -- aside from the annual "loss" on the equity, would there need to be an upfront write down or provision expense?
>>
>> Ron
>>
>>> On Feb 15, 2017, at 9:25 PM, Gadi Mayman <Gadi.Mayman@ofina.on.ca> wrote:
>>>
>>> That'd be a tough one to explain to ratepayers, and the OEB, whom I'd assume would have to opine on any ROE.
>>>
>>> If the external cost of borrowing for OPG is at 5 per cent, then you could theoretically have an ROE of 5 per cent to meet the parameters of the model. If the external cost of borrowing is higher than that, which we won't know in advance, the ROE would would have to be lower, so if, for example, the borrowing cost is 6 per cent, we'd only be able to have an ROE of 4 per cent (I'm simplifying the 49/51 to 50/50).
>>>
>>> I'm not a communications person, so maybe they could explain it, but whatever ROE we have, I'm still stuck on the point I raised in my last email: how to give a simple answer to the public about why they should be paying interest to someone outside the system and an ROE to the government to lower their bills.
>>>
>>> I know the interest cost would have to be explained even under the previous model of 100% government lending to the entity. People might be less fussed about that, the same way as they're less concerned about the tolls on the new section of the 407 than the old section, as someone I heard say on the radio, "at least we're paying it to ourselves instead of to a Spanish construction company." Converting it to equity instead of debt adds to the complication of explaining it, I'd think.
>>>
>>> Of course, given the alternative of the whole thing hitting the fiscal plan, maybe this is still better...
>>>
>>> Original Message
>>> From: Nelms, Scott (ENERGY)

>>> Sent: Wednesday, February 15, 2017 8:59 PM
>>> To: Gadi Mayman; Scott Thompson (CAB)
>>> Cc: David McLean (MOF); Ronald Kwan; Ken Kandeepan; Lynsey Wynberg; Nancy Kennedy (MOHLTC)
>>> Subject: Re: Call with OPG
>>>
>>> I agree. It would be a direct cost to ratepayers. There is a 5 percent cost of capital assumption embedded in the model, so we would want to get as close as possible to that (or less) on an all in basis. Not sure if that is feasible with 50 percent equity.
>>>
>>> We can confirm with OPG what is being assumed - last I heard they needed some amount of potential for profit (but it can be small) in order to meet the test to consolidate the Trust to OPG's financials.
>>>
>>> Sent from my BlackBerry 10 smartphone on the Rogers network.
>>> Original Message
>>> From: Gadi Mayman
>>> Sent: Wednesday, February 15, 2017 8:46 PM
>>> To: Nelms, Scott (ENERGY); Thompson, Scott (MOF)
>>> Cc: McLean, David (MOF); Kwan, Ronald (OFA); Kandeepan, Ken (OFA); Wynberg, Lynsey (OFA); Kennedy, Nancy (MOF)
>>> Subject: Re: Call with OPG
>>>
>>>
>>> I'd think, off the top of my head, but would be happy to be corrected by the accountants, that any ROE would be a one-for-one hit to the ratepayer for every dollar we give to the fiscal plan. I'm not sure how that would be explained to ratepayers: you're paying interest to private investors and a return on equity to the Province so that your bill is lower now, but will be higher later?
>>>
>>> Original Message
>>> From: Nelms, Scott (ENERGY)
>>> Sent: Wednesday, February 15, 2017 8:19 PM
>>> To: Gadi Mayman; Scott Thompson (CAB)
>>> Cc: David McLean (MOF); Ronald Kwan; Ken Kandeepan; Lynsey Wynberg; Nancy Kennedy (MOHLTC)
>>> Subject: Re: Call with OPG
>>>
>>>
>>> Hi Gadi,
>>>
>>> Thanks for passing this along. We had been hearing from OPG that the equity thickness would be relatively modest. 49 percent is certainly a departure from that. We also heard that some sort of return on the equity would be required in order to meet accounting objectives (although based on the email chain below perhaps that has evolved).
>>>
>>> If an ROE is included, would that help to offset the fiscal downside that you describe? We have to be careful in adding materially to the cost to ratepayers, so will have to look at this tradeoff.
>>>
>>> Scott
>>>
>>> Sent from my BlackBerry 10 smartphone on the Rogers network.
>>> From: Gadi Mayman
>>> Sent: Wednesday, February 15, 2017 6:59 PM
>>> To: Thompson, Scott (MOF)
>>> Cc: McLean, David (MOF); Kwan, Ronald (OFA); Kandeepan, Ken (OFA); Wynberg, Lynsey (OFA); Nelms, Scott (ENERGY); Kennedy, Nancy (MOF)
>>> Subject: Fw: Call with OPG
>>>
>>>
>>> Hi Scott. In the roller coaster ride with whether the OPG solution for the GA works, we've just hit a pretty big bump, as you'll see from Ken's email below. I suggest that you scroll down and read that before carrying on with my email, as what I'm going to write next may be hard to follow without the context of Ken's email.
>>>
>>> If we inject equity in the quantity OPG Is suggesting, it should make it easier for them to borrow externally,

although they'd have to sound out the market and find out whether they can, and, more importantly, at what additional cost relative to the Province's funding cost. It may require a provincial guarantee, which we used to give to the old Ontario Hydro, but I don't know whether that also is something that would affect their GBE status.
>>>
>>> Possibly of more significance is that IOD would rise substantially. If we make an equity contribution of half of the total amount they need for the GA, we'd have to borrow money without any offsetting earnings. It would start off in manageable amounts in the early years, but as the equity stake grows, the amount of interest does as well. In the scenario that Ron showed you this afternoon where interest made up up $30 billion of the total cost, about $15 billion in IOD would be added over the life of the option, if debt and equity are repaid at an equal pace to each other in the out years. Of course, if we discard this option and put this on the fiscal plan, IOD also goes up, but it would eliminate the need for OPG to borrow at a higher cost than the Province's borrowing cost.
>>>
>>> OPG apparently indicated on the call that they could increase their dividend to offset some of the cash that we're providing, which, on the surface would reduce our borrowing requirements and thus lessen IOD, but OPG would need to find the cash from somewhere else, so their interest costs would go up, reducing their earnings and hitting the fiscal plan that way. Since our cost of borrowing is lower than theirs, I'm not sure having them send us money makes fiscal sense. And, of course, hanging over this whole discussion is that OPG needs over $10 billion over the coming years to finance the Darlington refurbishment.
>>>
>>> Happy to discuss further at your convenience.
>>>
>>> Gadi
>>>
>>>
>>>
>>> From: Ken Kandeepan <Ken.Kandeepan@ofina.on.ca>
>>> Sent: Wednesday, February 15, 2017 6:09 PM
>>> To: Gadi Mayman
>>> Cc: Lynsey Wynberg; 'Veinot, Cindy (TBS)'; Ronald Kwan
>>> Subject: FW: Call with OPG
>>>
>>>
>>> Hi Gadi
>>>
>>> As discussed pls find a quick summary of our call with OPG. I understand that you will be passing this on to Scott. Cindy, you may wish to so to Helen as well.
>>>
>>>
>>> As requested by OPG, Cindy and I just finished a conference call with them. OPG is of the opinion that OEFC lending the full amount to either OPG or the Trust will seriously jeopardize the OPG's GBE status.
>>>
>>> In order to maintain the status they propose;
>>>
>>> That funding from the Province be limited to 49% of the amount required by the Trust and be in the form of an equity injection from the Province. An equity injunction means that the Province's net debt is not impacted since the increase in total debt is offset by an equivalent increase in the investment in OPG.
>>>
>>> OPG also asserted that the balance 51% has to be from an outside lender in order to preserve OPG's GBE status.
>>>
>>> Another reason for OPG also preferring the equity option instead of the Province lending the 49% is that they believe incorporating so much debt in their balance sheet with no offsetting income to service the debt will jeopardize their credit rating and impact OPG's "going concern" concept.
>>>
>>> From the Province's perspective there will be a material impact to IOD.
>>>
>>> John Lee indicates that OPG can in fact increase dividends to offset the cash impact of the increased IOD, but that doesn't help from a fiscal perspective. Unless OPG's net income increases and I am not sure that is possible since setting up the Trust does not contribute to net income, IOD and consequently the fiscal plan will be impacted fairly substantially as the equity injection ramps up.
>>>
>>> I indicated to John that I will run this by you and get back to him tomorrow, but given the possible fiscal impact, not sure how doable this is.

>>>
>>> Thanks
>>>
>>> Ken k
>>>
>>> ________________________________
>>>