<u>Province's Global Adjustment Proposal</u>

Date: Feb 10, 2017

Current conclusion: None of the alternatives would achieve the province's objective and the deferred costs will likely be added to Provincial deficits and net debt.

- It is unlikely that regulatory assets could be set up given most of the deferred amounts are not OPG incurred costs. (Appendix 1 outlines of criteria that need to be met for regulatory assets to be recognized by OPG or any new financing entity).

- Receivables can only be recognized if it is receivable from an identifiable party. However, if the other party is a provincial agency, an offsetting payable will be recognized, which will eliminate the receivable.

- If it is a securitization transaction, OPG or the Trust may record an asset (intangible asset – akin to a royalty). However, for the purposes for the Province's consolidation, the IESO (the seller of the cash flow stream) should record a liability to defer the "revenue" from OPG.

The Province may need to be mindful of IFRS and US GAAP difference given the uncertainty regarding GAAP to be applied.

Summary of issues:

1. **[Risk - Likelihood: High / Impact: High]** Province: The amount deferred may be recorded directly through deficit in the year of deferral (i.e. if $10B is deferred, the provincial deficits may increase by the same amount.)
2. **[Risk - Likelihood: Medium / Impact: High]** OPG: Assuming the transaction takes place inside of OPG, depending on the form of legislation, OPG may not be able recognize the assets on its balance sheet.
3. **[Risk - Likelihood: High / Impact: Medium]** Province: Even if a "receivable" can be recorded, net presentation likely will not be achieved and balance sheet may show the additional debt.
4. **[Risk - Likelihood: Medium / Impact: Medium]** Province: Can the OPG HoldCo apply GBE accounting?
5. **[Risk – Likelihood: High / Impact: High]** Province: If it is structured as a securitized transaction, OPG / Trust may be able to record an asset for the cash flow streams it purchased. However, the IESO may need to recognize such transaction as a borrowing.

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1. **The amount deferred may be recorded directly through deficit in the year of deferral (i.e. if $10B is deferred, the provincial deficits may increase by the same amount.)**

   Currently, none of the entities proposed to finance the deferred amount will be able to record the regulatory assets for the deferred amount:

   - The IESO applies PASB, and does not apply ASC 980 or IFRS 14 for rate regulated accounting

- For OPG, regulatory assets can only be recognized for costs incurred for services provided specific to the entity. In this case, the deferral is not for costs incurred for services provided based on OPG's current rate regulation. As such, regulatory assets cannot be recognized under ASC 980 or IFRS 14 under IFRS.
- The Finance Trust is not currently regulated by the OEB. For an entity to set up a regulatory asset, the entity needs to be in a regulatory regime using "cost of service model" whereas the deferral of costs is cost incurred for that the business.

As such, for the deferral to be recognized on the balance sheet as an asset outside of rate regulated accounting, the amount would have to be a "normal" receivable. However, a "normal" receivable can only be recognized if there is an identifiable counterparty (i.e. future customers are not identifiable counterparties). As such, the receivable likely cannot be recognized. If the other identifiable counterparty is a government agency (i.e. the IESO owes the Finance Trust), the Finance Trust would record a receivable and the IESO would record a payable, resulting in no net assets, but the debt financing would remain on consolidation. This will add to the Province's net debt and deficit.

Historically, the AG had questioned the validity of regulatory assets and liabilities for the Province's financial statements since they are created by the government's regulation. The AG has accepted those as assets on the basis of ASC 980. However, if the deferred balance is not a regulatory asset, there is a high likelihood that the AG would conclude a mechanism set up by the government to be collected from future customers would not be considered an asset that could be recognized under the PASB standard. This is akin to not recording a receivable for future tax increases or a receivable for debt retirement charges to be levied in the future. **[Confirm with Province/PwC]**

2. **OPG: Assuming the transaction takes place inside of OPG, depending on the form of legislation, OPG may not be able recognize the assets on its balance sheet.**

OPG can only recognize a regulatory asset if cost has been incurred to provide services to customers. Unless a legislation or regulation is set up that would make the deferred payments incurred costs to service customers, OPG cannot record the deferred amounts as regulatory assets **(appendix 1)**.

If the activities are not eligible for rate regulated accounting, to record an asset for the amount deferred, OPG would have to look at potentially recording the amount as a receivable from a specific party. Depending on the mechanism to be outlined, the legislation must point to the specific party (i.e. the IESO) having the responsibility to fund the amount (outside of the future customers). However, this may create an issue for the other party (IESO) since such legislation may also suggest that the other party should record a payable to OPG, which will be eliminated upon consolidation as discussed above.

3. **Province: Even if a "receivable" can be recorded, net presentation likely will not be achieved on the Province's financial statements. This may affect the Province's credit rating.**

   Based on discussion above, any receivables would likely result in a payable in the other entity (IESO) which will be consolidated by the Province. This will produce a net liability reflecting in a net liability on consolidation representing the debt issued to finance the deferral amount.

4. **Province: Can the OPG HoldCo apply GBE accounting?**

   OPG HoldCo must meet the following to apply GBE accounting:

   a) Separate legal entity with power to contract in its own name and that can sue and be sued;
   [YES – needs to have its own board and manage OPG Inc. and the Trust]

   b) Has been delegated financial and operational authority to carry on a business
   [Not sure, if the HoldCo carries on a business – need to support the Trust carry on business as well]

   c) It sells goods and services to individuals and organizations outside of the government reporting entity as its principal activity;
   [Need to support that it sell goods/services to customers – a description of the Trust's goods and services is needed]

   d) It can, in the normal course of its operations, maintain its operations and meet it liabilities from revenues received from sources outside of the government reporting entity.
   [Questionable given the substantial liability the entity would be financed, this would be the case for OPG and the Trust.]

5. **Province: If it is structured as a securitized transaction, OPG may be able to record an asset for the cash flow streams it purchased. However, the IESO may need to recognize such transaction as a borrowing.**

   The conclusion and the following are consistent with advice received from PwC based on a call on Feb 10, 2017. Also see the PwC guidance below. OPG cannot recognize the amount as a financial asset. Current conclusion is that OPG/Trust would recognize the future cash flow stream as an intangible asset. It is unclear, however, if the IESO would can recognize revenue and avoid recognizing a liability if the future cash flow stream from future customers are purchased from them.

   Question 17-18 Are securitized stranded costs financial assets?

   <u>PwC response:</u>
   No. Reporting entities may sometimes securitize their enforceable right to impose a surcharge or tariff. When a reporting entity securitizes its stranded costs, it obtains cash from investors in

exchange for future regulated cash flows representing the surcharge or tariff. Such securitizations are typically set up through a trust that sells the securities and administers the ongoing cash flows related to those securities. ASC 860, Transfers and Servicing, provides specific guidance on securitized stranded costs and states that they do not meet the definition of a financial asset. ASC 860-10- 55-7 through 55-8 indicate that securitized stranded costs are not financial assets because they are imposed on ratepayers through the surcharge or tariff (i.e., imposed by the government) and do not represent a right to receive payments from another party as a result of a contract. Therefore, reporting entities should evaluate transfers of stranded costs in a securitization transaction as a borrowing and consider consolidation requirements related to the securitization trust.

Appendix 1 – Requirements to apply rate regulated accounting:

The following is precluded to apply rate regulated accounting:

- Accounting for price controls that are imposed by governmental action in times of emergency, high inflation, or unusual conditions, or accounting for contracts in general.

Requirements to apply rate regulated accounting:

- Need to define what is the regulated goods and services the entity is providing
- Rates are established by the OEB or a governing board
- The right is empowered by statute that bind customers
- Rates are designed to cover specific entity's costs
- Cause and effect relationship between the specific costs and revenue
- Rate are designed to recover incurred costs plus a return on rate base