Ontario

LEGISLATION AND REGULATIONS COMMITTEE BRIEFING NOTE

Energy

Draft based on draft materials- Fair Hydro Plan Implementation

Cabinet (info) Feb 15, 2017	TB/MBC and Cabinet March 1, 2017	Announcement March 2, 2017	TB/MBC May 9, 2017	Cabinet May 10, 2017
Introduction May 11, 2017	Royal Assent June 1, 2017	TB/MBC June 27, 2017	Cabinet (DTC) June 14, 2017	Cabinet (DTC) June 27, 2017
Program Effective Date July 1, 2017	TB/MBC September 25, 2017	Cabinet September 27, 2017	LRC/ Cabinet October 30, 2017	LRC November 20, 2017

Summary of Proposal

The proposed regulations are consistent with Cabinet direction.

Context for Decision:

On March 2, 2017, the government announced Ontario's Fair Hydro Plan (OFHP). One component of OFHP is refinancing a portion of the Global Adjustment (GA). The implementing legislation for GA refinancing, the *Ontario Fair Hydro Plan Act, 2017* (OFHPA), which is Schedule 1 under the *Fair Hydro Act, 2017* (FHA) was introduced May 11, 2017 and received Royal Assent on June 1, 2017. The OFHPA expands the powers of Ontario Power Generation (OPG), the Ontario Energy Board (OEB) and the Independent Electricity System Operator (IESO) and puts in place mechanisms including appropriate payment settlement and cost-recovery authorities for and through IESO to manage the deferred GA costs.

On June 14, 2017, new regulations were created under the OFHPA that support calculations related to GA refinancing and one existing regulation was amended to authorize IESO to fund the regulatory asset as part of the financing structure. On June 27, 2017, a new general regulation (Ontario Regulation 206/17) was created under the OFHPA that details the roles and responsibilities of the Financial Services Manager (i.e., OPG), IESO and OEB.

Proposal:

This proposal is the next step in the implementation of GA refinancing. The Ministry of Energy (ENERGY) is proposing amendments to Ontario Regulation 206/17 (General), under the OFHPA, and Ontario Regulation 429/04 (Global Adjustment), under the Electricity Act 1998 (EA), that are required to address accounting and commercial/financing requirements that would allow GA refinancing to proceed as planned.

Why does Ontario need these changes? Why now?

Addressing rising electricity prices is among the highest priorities for Ontarians. The OEB adjusted rates to reflect OFHP reductions partially on May 1, 2017 and fully on July 1, 2017. As a result, IESO has managed the GA deferral with its existing resources since that time. As such, it is important for the proposed amendments to take effect in a timely manner to enable OPG to go to market to fund the GA deferral by transferring the regulatory asset to the OPG financing entity (i.e., Fair Hydro Plan Trust). ENERGY understands that OPG intends to go to market in late November or December 2017 and is currently in formal discussions with rating agencies and financial advisors with respect to timing and other aspects of its FSM role. According to the ministry, OPG as FSM has advised that the proposed amendments are critical for it to proceed with the initial debt issuance.

The ministry advises that the rating agencies have indicated that they will not be able to complete their analysis to issue a rating of the debt until the proposed regulations are in place. The credit rating of the debt is required before OPG can go to market. Note: OPG is planning to go to market in late November or early December 2017.

How will this proposal impact Ontario?

Under the OFHPA, electricity bills for a typical residential consumer have been reduced by 25 percent effective July 1, 2017, compared to what they would have been without the initiatives included in the OFHP. The OFHPA also provides that further increases to electricity bills for a typical consumer are to be held to the rate of inflation for a period of four years, after which bills will increase and ultimately over the 30 year terms of the program will recover the amounts deferred during the early years of the program as well as all of the financing costs related to the deferral.

The proposed amendments would support the implementation of the OFHP, which affects all “specified consumers,” as defined in the OFHPA, to whom the “Fair Adjustment” applies. Prescribed consumers include residential consumers, farms, small businesses, condominiums, long-term care homes and co-operative housing. These include consumers eligible for the Regulated Price Plan (RPP). Eligibility is aligned with the eligibility under the *Ontario Rebate for Electricity Consumers Act, 2016* (ORECA). In addition, ENERGY notes that up to 500,000 small businesses and farms are also benefitting from GA refinancing.

What is the expected cost to government?

The ministry reports that the proposal is not expected to have any fiscal impact on Ontario.

The GA refinancing structure, which provides current relief to specified ratepayers, followed by recovery of the deferred amounts from that same class of ratepayers (e.g. fully on the ratebase) will result in: (1) an increase in provincial gross debt (to finance the equity injection in OPG), with no increase to net debt, as the gross debt increase is offset by an increase in the government's assets in the form of a higher equity investment in OPG, and (2) an increase in interest on debt paid by the Province, assumed in the fiscal plan as exactly offset by higher earnings from OPG, resulting in no assumed impact to the Province's fiscal position. The actual impact will depend on actual IOD and OPG net income impacts. The proposed regulatory amendments would support the implementation of this refinancing structure.

The proposed amendments to O. Reg. 429/04 would impact IESO and licensed distributors in relation to their role in the recovery of amounts associated with the security arrangement payable by consumers through GA. The cost would be dependent upon interest rates, the amount of the letter of credit and the perceived risk of default by IESO. Initial estimates indicate that this would result in an annual carrying cost of about $1 million from 2021 to 2047. In the unlikely event of a default of one of the LDCs covered by IESO, the costs would increase to cover any shortfall.

The ratepayer impact of the carrying cost of the letter of credit would be negligible.

Commented [CV1]: I don't think this regulation impacts the LDCs.

Commented [HT2]: What is the anticipated rate impacts of this security arrangement

Commented [CV3]: Did the IESO or Energy provide a synopsis of the purpose of the reg – my understanding is that the IESO is required to post of letter of credit to the credit of the financing entity related to any financial failure of an LDC that does not have a credit rating (e.g. the smaller ones), and that this amendment to the reg is to allow the IESO to recover the cost of posting the LC from the specified ratepayers.

What are the key steps to deliver this proposal?

The proposed regulations would take effect on the date they are filed.

Amendments would provide further detail on the roles and responsibilities of the OPG, IESO and OEB with respect to GA refinancing. Key steps for the delivery of this proposal include:

- OPG to produce Financing Plans that set out funding obligations for each reference period consistent with the Fair Allocation Amount (FAA).
- IESO to record deferral amounts in relation to the establishment of the regulatory asset.
- OPG to proceed with initial debt issuance in late November or early December 2017.
- OPG to purchase Regulatory Asset from IESO on monthly basis.
- OPG to issue long-term bonds periodically.
- Province to inject capital into OPG periodically as required.

Commented [CV4]: The Reg notes that Section 3 comes into force on May 1, 2021.

Commented [CV5]: This reg does not impact OPG or the OEB from my read of it.

Commented [HT6]: Energy- outline OPGs process for marketing and dela closing- i.e. 1 week marketing period followed by 3 day deal period etc.

How often do we expect OPG to go to market with each tranche? As needed? Quarterly? Etc.

How will the changes be communicated?

- The ministry does not plan to proactively communicate on the regulatory amendments. Ministry has an extensive broader OFHP communications strategy in place.
- Reactive materials will include updated Q&As, key messages and issues management plan.
- The ministry will continue to monitor and track:
  - media reactions and editorials
  - incoming correspondence
  - response by opposition MPPs

Cabinet Office Analysis

The Ministry of Energy's (ENERGY) proposed regulatory amendments are consistent with Cabinet direction provided for the implementation of GA refinancing as part of Ontario's Fair Hydro Plan (OFHP) on March 1, 2017. The *Ontario Fair Hydro Plan Act, 2017* (OFHPA) establishes the framework to refinance a portion of current Global Adjustment (GA) costs as part of OFHP.

OFHP reduced a typical residential consumer's electricity bills by 25 per cent, on average, effective July 1, 2017, compared to what they would have been without the initiatives under the Plan. The refinancing methodology defers a portion of current GA costs to the same class of ratepayers in the future in order to allocate costs across present and future generations of electricity consumers with respect to investments made to decarbonize (e.g., phase-out coal) and modernize Ontario's electricity system (e.g., build and maintain a reliable electricity system).

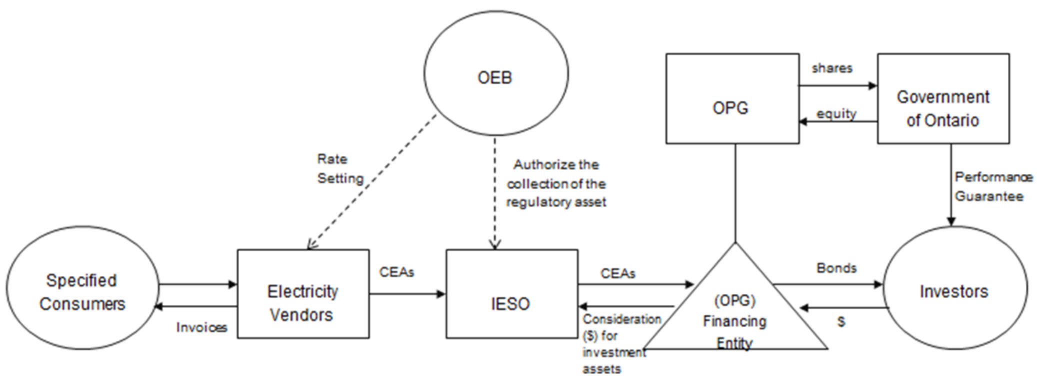
Refinancing Structure

Under the GA refinancing structure, the Independent Electricity System Operator (IESO) records the GA cost recovery deferral as a regulatory asset to be collected at a future time from specified consumers ("the Fair Adjustment" and "IESO deferral"). As a result, specified consumers will receive a reduction in electricity rates from July 1, 2017. The IESO may then sell the regulatory asset, at which time it becomes an investment asset in the OPG financing entity.

The Minister of Energy, following the principles in the Act and regulations, will regularly calculate the Fair Allocation Amount (FAA) to ensure a proper alignment of the allocation of the intergenerational costs and benefits in relation to each of the next 60 six month reference periods. Based on the FAA, the Financial Services Manager (OPG), through financing entities, will debt finance the deferred portion of the GA cost. The financings will be backed primarily by the clean energy adjustments payable by specified consumers. The clean energy adjustments will track the actual payment obligations incurred by the financing entities when they become due and payable.

OPG, in its role as the Financial Services Manager (FSM), will calculate the aggregate clean energy adjustment payable in each month of the reference period, and, to ensure intergenerational fairness, these amounts will be managed to ensure consistency with the fair allocation amounts. OEB will calculate the rates at which the clean energy adjustment will be collected from specified consumers.

To recoup the costs associated with the fair adjustment, consumers will be invoiced the clean energy adjustment on their electricity bills through existing IESO and Local Distribution Companies' (LDC) processes, which will be channeled through to pay each financing entity's related funding obligations. When the government was developing its OFHP financing structure proposal, it was originally intended that the clean energy adjustments would appear on customer's bills at the beginning of the repayment period. However, under the OFHPA, clean energy adjustments will appear on customer's bills once the inflationary cap period is complete. These payments are expected to be nominal as they will represent interest payments, and not repayment of the principal. The principal will be included when the repayment period begins in the late 2020s.



Note: CEAs are "clean energy adjustments".

In its capacity as FSM under the GA refinancing structure, OPG will take on the risk and responsibility of financing the deferral, with the financing entity purchasing monthly regulatory assets from IESO. OPG will finance these purchases through a combination of an equity investment by the Province and external private sector financing.

Proposal

The proposed regulatory amendments would enable OPG to go to market to fund the GA deferral.

Amendments to O. Reg. 206/17 (General) under the OFHPA

The Ministry is proposing amendments to O. Reg. 206/17 that would set out an approach to appropriately managing a potential acceleration of debt repayment in the event of a financing entity default, including impacts on Clean Energy Adjustments (CEAs) payable by specified consumers. The ministry reports that there is a low risk of a default and therefore a low risk of the proposed mechanism being required. However, the mechanism is required to be in place in order to give certainty to the market and credit rating agencies in the unlikely event it was ever needed.

Additional proposed amendments would clarify the operation of O. Reg. 206/17, including the recovery of financing entity carrying costs during the period after May 1, 2021, in which the FAA, as defined under the OFHPA, is less than the amount of such carrying costs.

Amendments to O. Reg. 429/04 (GA) under the Electricity Act

In order for OPG to market the debt, a security arrangement is required to backstop smaller Local Distribution Companies (LDCs) without any or a sufficiently sound credit ratings during the years in which CEAs are collected from consumers (i.e., currently 51 of 66 LDCs are market participants not rated by credit rating agencies). A mechanism is required to enable IESO to recover costs associated with the security arrangement, including carrying costs and any default costs.

Proposed amendments to O. Reg. 429/04 would enable the recovery of such costs from consumers through GA. In the event of an LDC default, which would result in CEAs not being recovered from the relevant LDC, the amounts related to uncollected CEAs would be recovered from specified consumers, as defined under the OFHPA, through GA. ENERGY advises that the risk of a LDC default is considered to be low, and the ratepayer impact of the carrying cost of the letter of credit would be negligible. In the unlikely event of a default of one of the LDCs covered by IESO, the costs would increase to cover any shortfall.

Commented [HT7]: Does the recovery of default costs only apply to those LDCs with insufficient or non existing credit or all LDCs theoretically? I understand that the structure needs the certainty of this, but is there also a mechanisms to try and recover what is owed from the defaulted LDC?

Commented [CH(8]: Any default costs would be recovered from all specified consumers as defined in the legislation, i.e. those that are benefitting from GA refinancing.

These proposed provisions would come into effect after the inflationary cap period (i.e. post May 1, 2021) but are required now for the mechanism to be in place before OPG goes to market with the debt.

Stakeholder response:

ENERGY consulted with representatives from the OEB, IESO and OPG, as well as external advisors (i.e., lawyers, accountants and underwriters) and other ministries as appropriate on the proposed regulatory amendments. Consistent with the approach taken to develop and implement the OFHPA, a steering committee chaired by ENERGY's Deputy Minister met bi-weekly on the status of the proposed regulatory amendments. The committee consists of senior executives from ENERGY, Cabinet Office, Ministry of Finance, Treasury Board Secretariat, Ontario Financing Authority, OPCD, OPG, OEB and IESO.

General public – Generally supports the GA refinancing initiative, but also question the longer term implications. Some individuals and organizations perceive the GA smoothing as unduly burdening future generations.

OPG in its role as FSM - OPG is supportive of amendments that will address accounting and commercial/financial requirements.

OEB - OEB is supportive of an approach that clearly defines the roles and responsibilities of the Board in relation the recovery of costs associated with the security arrangement through the GA.

IESO – IESO is supportive of an approach that clearly defines a mechanism for the recovery of costs associated with the security arrangement through the GA.

Risks:

OPG Mechanism

There are several risks associated with the OPG/SPV mechanism that remain. OPG/SPV could continue to be criticised for not having an appropriate level of accountability to the government or the public, due to the limited amount of government control of the entity, and future rate increases. However, this is seen by the markets as an essential component for the structure to operate and the government remains the sole shareholder of OPG.

Complex Accounting and Financing Structure

On October 24, 2017, the Auditor General of Ontario released a special report in on the Fair Hydro Plan. The Auditor General expressed concerns with respect to the province's accounting methods under the OFHP and noted that the financing structure could result in significant costs for Ontarians. In the Auditor General's view, the accounting structure is needlessly complex.

The proposed regulatory amendments would further implement and build on a complex financing structure that is unique to Canada— uniqueness reduces likelihood of all risks being known and mitigated. It should also be noted that highly specialized expertise has been required to get to this point and external private sector financing is still not certain.

ENERGY notes that the development of the proposed amendments was preceded by extensive consultation with representatives from OEB, IESO and OPG, as well as their external advisors (i.e., lawyers and accountants).

Legal

In principle, refinancing the GA to spread the costs of generation and conservation assets over the useful life of the assets presents only a low risk of being an unconstitutional tax, as each cohort of consumers pays for a proportion of the GA cost roughly equal to the proportion of the benefit they receive from the useful life of the assets. Legal risk arises if it becomes apparent that the government is not spreading cost so that it is shared proportionately by future consumers who cause a need for or benefit from the asset, but rather is doing so in order to lower the price in the short term by increasing the price in the long term. If the proposed financing served to encumber future consumers with a premium payment to cover the GA financing in order to subsidize current ratepayers, then there would be a moderately high constitutional risk that the financing proposal would result in an unconstitutional tax.

The legislation contains provisions to mitigate the constitutional law risks, including requiring the Minister of Energy to reallocate estimated clean energy costs attributable to each reference period in a way that takes into account the need to align those costs with the estimated clean energy benefits attributable to the same period.

Linkages:

Long-Term Energy Plan (LTEP) – Ontario released the 2017 LTEP on October 26, 2017.. The LTEP identifies needs for investments over the shorter term, while broadly mapping out the direction of the sector over a 20 year timeframe. The LTEP is intended to balance the principles of affordability, reliability, clean energy, community and Indigenous engagement, as well as conservation and demand management.

Electricity Rate Mitigation Initiatives – The *Ontario Rebate for Electricity Consumers Act, 2016*, (ORECA) put in place a rebate for an amount equivalent to the 8% provincial portion of the HST for eligible residential, small business customers and farms, beginning January 1, 2017.

Rural and Remote Rate Protection (RRRP) and Delivery Rate Protection (DRP) – RRRP and DRP help to offset the higher costs to distribute electricity to Ontario residents who live in rural or remote locations all across the Province. DRP was established under the FHA and regulations approved June 14, 2017. Both the expanded RRRP and DRP were implemented July 1, 2017.

The Ontario Clean Energy Benefit (OCEB) – Was a five-year legislated program put in place as a broad-based, transitional measure to a cleaner electricity system. OCEB was also put in place following the implementation of the Harmonised Sales Tax (HST). Unlike the previous provincial Retail Sales Tax (RST), the HST (and GST) included electricity in the taxable base. OCEB program ended on December 31, 2015.

Debt Retirement Charge – On January 1, 2016, the government ended the electricity DRC on residential users, which was earlier than previously estimated. For all other consumers the DRC will be removed by April 2018, also earlier than previously estimated.

Industrial Conservation Initiative (ICI) – Implemented in January 2011 to help large industrial consumers reduce electricity costs by reducing consumption in peak periods. ICI eligibility has been expanded several times, and was most recently expanded, as part of the OFHP, to allow for the participation of the manufacturing and, e.g., greenhouse sectors with an average month peak demand down to a range of greater than 500 kilowatts (kW) and less than or equal to 1 megawatt (MW). ICI provides a benefit to all consumers by decreasing the need for costly peaking generation over the long term.

Affordability Fund – Approved as part of OFHP, the Affordability Fund is intended to provide energy efficiency measures to Ontarians who are not eligible for low income conservation programs, and who are otherwise unable to make energy efficiency improvements without financial assistance. The fund was officially launched in October 2017

Ontario’s Climate Change Action Plan (CCAP) – The CCAP, released in summer 2016, reiterated the 2016 Budget commitment and stated that Ontario intends to invest in initiatives that both reduce greenhouse gas (GHG) emissions and ensure that the net impact of cap and trade would not result in an overall increase in electricity costs for commercial and industrial consumers, and that there would be a modest benefit of up to $2 per month, on average, to residential consumers. This commitment to residential consumers was exceeded by the January 2017 8% rebate.

Other Jurisdictions:

According to ENERGY, this financing structure is similar to several jurisdictions in the U.S., and uses a form or securitization that is commonly used in the financial markets. The recognition of regulatory assets brings IESO in line with 6 other independent system operators in North America, including AESO, ISO New England, NYISO, MISO, PJM and ERCOT.

Terms you need to know

- **Global Adjustment (GA) –** The GA accounts for the difference between generation costs (contracted and rate-regulated) and the wholesale market price in order to recover fixed costs, including capital costs, of putting in place and operating Ontario's generation fleet, as well as the cost of conservation and demand management programs. The GA is instrumental in maintaining a reliable electricity system by ensuring that sufficient generating capacity is available.
- **Local Distribution Companies (LDCs) –** Local electricity utilities (e.g., Hydro Ottawa, Toronto Hydro, etc.) responsible for distributing power from transmission lines to people's homes and to businesses and institutions. LDCs recover their costs through distribution rates. LDCs are licensed to serve a specific geographic area by the Ontario Energy Board (OEB). An LDC must receive OEB approval to charge a distribution rate.
- **Regulated Price Plan (RPP) –** Since April 2005, the Ontario Energy Board (OEB) has administered an electricity price plan that provides stable and predictable electricity pricing, encourages conservation and ensures the price consumers pay for electricity better reflects the price paid to generators. This pricing plan is known as the Regulated Price Plan (RPP). About 5 million residential consumers, small businesses and farms are eligible for the RPP.
- **Ontario Power Generation (OPG) –** A business corporation owned by the Province that owns and operates generation assets, including nuclear and hydro, and generates almost half of Ontario’s electricity.
- **Ontario Energy Board (OEB) –** A Crown Agency that independently regulates Ontario’s electricity and natural gas sectors in the public interest. Implements an open and transparent process to allow for stakeholders to participate in quasi-judicial proceedings and formal stakeholder consultations.
- **Independent Electricity System Operator (IESO) –** An independent corporation established under the *Electricity Act, 1998* that operates the electricity market in Ontario. Balances the supply of and demand for electricity in Ontario and then

directs its flow across the province’s transmission lines, including interties with other jurisdictions.