RE: OPG Performance fees

From: Ken Kandeepan <ken.kandeepan@ofina.on.ca>
To: "Nelms, Scott (MOF)" <scott.nelms@ontario.ca>
Cc: "Kwan, Ronald (OFA)" <ronald.kwan@ofina.on.ca>, "Manning, Mike (OFA)" <mike.manning@ofina.on.ca>, "Yep, Carlos (OFA)" <carlos.yep@ofina.on.ca>, "Veinot, Cindy (TBS)" <cindy.veinot@ontario.ca>
Date: Sun, 21 May 2017 10:42:32 -0400

Hi Scott

Sorry for the delay in responding, after a discussion with Gadi the OFA is comfortable with the approach proposed by OPG. We also recommend that the $1M upside/downside limit on performance fees in relation to a pre-determined benchmark be enshrined in the Financing Plan to be developed by OPG. The OFA is also willing to work with OPG on the development of the benchmark.

Thanks

Ken k

From: Nelms, Scott (MOF) [mailto:Scott.Nelms@ontario.ca]
Sent: Monday, May 15, 2017 9:17 AM
To: Ken Kandeepan <Ken.Kandeepan@ofina.on.ca>
Cc: Ronald Kwan <Ronald.Kwan@ofina.on.ca>; Mike Manning <Mike.Manning@ofina.on.ca>; Carlos Yep <Carlos.Yep@ofina.on.ca>; Veinot, Cindy (TBS) <Cindy.Veinot@ontario.ca>
Subject: RE: OPG Performance fees

I talked to OPG on this. Here are some other considerations:

- Risk / reward goes both ways. Unlike most management fee structures where the performance fee provides an at risk upside to the manager, but no downside, the distribution of potential benefits and losses is symmetric between ratepayers and OPG.
- OPG's current thinking is that it would work with OFA to set a benchmark for borrowing costs at the start of the year based on GOC yields + a premium. If OPG over-performs (under-performs) the benefit (downside) would be shared between the company and ratepayers 50/50 up to +/- $1M. Above or below $1M, all of the benefit (downside) would flow to ratepayers.
- OPG does not particularly like this symmetry but this is apparently required to meet accounting requirements.
- From my perspective, $1M is a small number, so I am not too concerned about overall impacts on ratepayers.

Thanks,
Scott

From: Ken Kandeepan [mailto:Ken.Kandeepan@ofina.on.ca]
Sent: May 13, 2017 7:32 PM
To: Nelms, Scott (MOF)
Cc: Kwan, Ronald (OFA); Manning, Mike (OFA); Yep, Carlos (OFA); Veinot, Cindy (TBS)
Subject: RE: OPG Performance fees

Hi Scott

Yes the MOF does like OPG to make money since on a PSAB basis it benefits the Province's fiscal position. In this instance however, the marginal increase to the fiscal bottom line comes at the expense of the ratepayers in terms of additional debt, hence our push back.

Pls see below my responses on the two issues that you have raised. I am cc'ing Cindy as well since she may have her own thoughts and a discussion maybe value added in terms of arriving at a common understanding.

Thanks

Ken K

From: Nelms, Scott (MOF) [mailto:Scott.Nelms@ontario.ca]
Sent: Friday, May 12, 2017 2:54 PM
To: Ken Kandeepan <Ken.Kandeepan@ofina.on.ca>
Cc: Ronald Kwan <Ronald.Kwan@ofina.on.ca>; Mike Manning <Mike.Manning@ofina.on.ca>; Carlos Yep <Carlos.Yep@ofina.on.ca>
Subject: RE: OPG Performance fees

MoF asking OPG to make less money! This feels so backward!

I will chat with OPG to dig in to the rationale. I take your point that OPG will benefit from the loans to the trust. However, I see two weaknesses with the argument:

1) Lenders don't typically consolidate borrowers, so it takes more than interest revenues to meet this test. Not sure if you are referring to the "Power" or "profit" principle. If the former the Province lends to IO for all its needs and yet exercises power since IO is consolidated with the Province in much the same way the Trust and OPG will be consolidated. Note that OPG benefits from the interest income on the 44% relating to the equity injection even if the Trust is not consolidated.
2) Earning interest income on equity is going to take down the company's ROE (one of the key metrics that we are tracking on overall company performance). Therefore I wouldn't see this as a particularly compelling allocation of funds from a commercial perspective. This is a good point however, OPG considers the 44% it lends to the Trust as sub-debt most likely priced higher than the debt borrowed by the Trust from the markets. In the event the interest on the 44% is less than OPG's current ROE of the company, your point holds however, if the interest is higher it actually adds to OPG's ROE.

Scott

From: Ken Kandeepan [mailto:Ken.Kandeepan@ofina.on.ca]
Sent: May 12, 2017 11:24 AM
To: Nelms, Scott (MOF)
Cc: Kwan, Ronald (OFA); Manning, Mike (OFA); Yep, Carlos (OFA)
Subject: OPG Performance fees

Hi Scott

This issue has come up a couple of times and after discussing with Gadi we felt that you may be able to raise it either directly with OPG or via Energy. As the Financial Services Manager, OPG is proposing a performance fee for itself based beating a benchmark for borrowing costs the Trust incurs in presumably the 51% it seeks to borrow from the capital markets.

OPG argues that the latter of the two fundamental principles, "Power" and "Profit" allowing the Trust to be consolidated with OPG requires the implementation of a performance fee structure. The counter argument is that OPG already has access to profit, by virtue of its position as the funding entity for 44% of the debt incurred by the Trust. OPG uses the funds it receives from the Province's equity injection, for which it pays no interest, for this purpose.

Upon consolidation with the Trust, OPG's interest income will therefore increase by the amount of the interest the Trust receives on 44% of its overall debt, a relatively risk free profit source, at least over the duration of the Fair Hydro Plan. While the use of a benchmark is appropriate and contributes to an efficient borrowing program, any performance fees arising from beating the benchmark will effectively be funded by the ratepayers, by increasing the investment asset and the associated debt to be repaid by ratepayers.

Mike and I will be happy to provide any further technical assistance that you may require as you raise this issue.

Thanks

Ken k
