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April 25, 2011

PRIVILEGED AND CONFIDENTIAL

Ontario Power Generation Inc.
700 University Avenue
Toronto, ON
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Attention: Mr. Carlton Mathias, Law Division

Dear Mr. Mathias:

Re: The Legal Basis of OPG's Regulatory Deferral and Variance Accounts

You have asked us to consider the legal basis of Ontario Power Generation Inc.'s ("OPG's") regulatory deferral and variance accounts in order to assist you in determining whether they are recognizable as "assets" and "liabilities" for financial reporting purposes under International Financial Reporting Standards ("IFRS").

In considering this issue, you have asked us to consider whether deferral and variance account balances are recoverable in a hypothetical circumstance where OPG ceases operations and does not have any energy output from its prescribed facilities. You have also asked us to consider how OPG can be assured that the amounts representing OPG's approved deferral and variance account balances will actually be paid to OPG, as well as whether OPG's ability to collect these amounts is dependent upon the renewal of the licence of the Independent Electricity System Operator.

I. CONCLUSIONS

OPG's deferral and variance accounts are established either by regulation or by orders of the Ontario Energy Board (the "OEB") through the proper exercise of its jurisdiction as the administrative tribunal responsible for regulating the electricity industry in Ontario. The establishing of such an account pursuant to regulation or the granting of approval by the OEB to establish such an account confers upon OPG a right to record amounts in the account and to account for the amounts recorded on the basis that they have been prudently incurred. Courts have found that prudence is deemed to exist until such time as the OEB (in its discretion), at a later date, values or assesses the balance of that account and determines that the recorded balance is wholly recoverable or that certain of the recorded amounts have in fact not been prudently incurred and are not recoverable.

Given that OPG's recovery or payment of the amounts recorded in its deferral and variance accounts, and subsequently disposed of by the OEB, are part of the calculation of OPG's payment amounts under section 78.1 of the *Ontario Energy Board Act, 1998* (the "OEB Act"), OPG is entitled to have recorded amounts assessed and to recover those amounts pursuant to

the OEB's order. Correspondingly, the OEB, as a matter of law, is obligated to establish OPG's payment amounts in accordance with the rules prescribed by the regulations and in accordance with the just and reasonable standard,[1] which standard has been affirmed by the Supreme Court of Canada. In establishing OPG's payment amounts, the OEB must assess the balances in the previously established accounts for prudence and accuracy and issue a Decision and Order on their disposition.

For certain of OPG's deferral and variance accounts, the legal origins of which are found in Ontario Regulation 53/05 ("O. Reg. 53/05"), under the OEB Act, the OEB does not have jurisdiction over whether the account may be established. For at least two of these accounts, the OEB also does not have jurisdiction to undertake a prudence review to determine if any recorded amounts should be excluded.

Once the OEB has approved the balance of an account for recovery, with or without undertaking a prudence review (as applicable), the specific amount or balance that OPG will be allowed to recover will have been determined. The subsequent issuance by the OEB of a payment amounts order will establish the mechanism by which such specific approved amounts will be recovered and remitted to OPG.

The OEB's review and approval of the balance in a deferral or variance account is a process for determining the quantum and timing for the payment to or from OPG in respect of that account, which will be reflected in a Decision and Order of the OEB. As indicated, OPG's legal right to record amounts in an account and to account for the amounts recorded on the basis that they have been prudently incurred, subject to the OEB in its discretion subsequently determining otherwise, is established through the authorization of the account by the OEB or pursuant to regulation. OPG's right to recover prudently incurred amounts therefore arises as and when such amounts are recorded in an approved account, in accordance with the parameters established by the OEB or by regulation for that account, subject to the OEB's subsequent prudence review to assess the value of the account.

In the circumstance where OPG ceases operations and does not have any energy output from its prescribed facilities, it is our opinion that the OEB would have the jurisdiction and the obligation to establish a rate or payment amount that would allow OPG to recover or obligate OPG to disburse prudent amounts recorded in a deferral or variance account. Such a rate or payment amount would not have to be based on dollars per unit of electricity output from the prescribed facilities. This is no different than under normal operating circumstances.

The OEB has broad jurisdiction in setting payment amounts for OPG and it would not be reasonable for the legislature to have given the OEB the legislative power to authorize the establishment of accounts without also giving the OEB the power to dispose of the amounts recorded in such accounts, including in circumstances where there is no future output. Moreover, to interpret the applicable legislation in a manner that only allows for payment

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[1] As described on p. 6, the OEB is required under Subsection 78.1(4) of the *Ontario Energy Board Act* to make payment amount orders in accordance with the rules prescribed under O. Reg. 53/05. Under Subsection 78.1(5) of the *Ontario Energy Board Act*, the OEB may in certain circumstances fix such other payment amounts (i.e. other than those arising from Subsection 78.1(4)) and such other payment amounts must be established in accordance with the just and reasonable standard. Accordingly, payment amounts will need to be established either in accordance with the just and reasonable standard or, if the amounts arise from matters addressed by the rules prescribed by O. Reg. 53/05 then those amounts shall instead be established in accordance with such rules.

amounts on a volumetric basis is in our view unreasonable because it would not be consistent with the rules of statutory interpretation.

Pursuant to Section 78.1 of the OEB Act, the IESO is required to make such payments to OPG in accordance with orders from the OEB. By statute, the IESO is established as a corporation, the business of which, by legislation, is to be carried out without the purpose of gain or profit. As such, all money it collects must be used for the purpose of fulfilling its obligations in respect of the IESO-administered market and the IESO-controlled grid. These purposes include the making of payments to OPG in accordance with orders of the OEB under Section 78.1. Moreover, by entering into participation agreements, the IESO and market participants such as OPG agree to be contractually bound by the Market Rules. To remain revenue neutral, consistent with its not-for-profit status, under the Market Rules, if any market participant fails to make a payment, including in respect of amounts associated with OPG's deferral and variance accounts, then the IESO has various remedies available to ensure it can collect the funds it needs to make the payments it is required to make to OPG and other generators.

In the context of the legislative scheme governing Ontario's electricity system, the IESO's licence is not the only aspect that gives authority to or imposes obligations on the IESO. In fact, the IESO has various statutory obligations which exist independently of the IESO's licence and are not undertaken by the IESO as a condition of the licence. The IESO's obligation to pay the payment amounts to OPG as a prescribed generator under Subsections 78.1(1) and 78.1(2)(b) is a legal obligation that is independent of the IESO's licensing requirements. Likewise, the OEB has a statutory obligation under Section 78.1 of the OEB Act to set payment amounts in accordance with the applicable regulation and the just and reasonable standard[2] and, although the recovery of the OEB-approved payment in accordance with its order is fulfilled by the IESO under Subsections 78.1(1) and 78.1(2)(b), the OEB's obligation to set such payment amounts is legally independent of the existence of the IESO's licence. If the licence ceases to exist, then the obligations of the IESO and the OEB under Section 78.1 would remain. For the OEB to fulfill its obligation to set payment amounts in accordance with the regulation and the just and reasonable standard[3], there is a need for there to be an effective mechanism in place that enables OPG to actually receive its payment amounts. Accordingly, the OEB would only be able to cancel or refuse to renew the IESO's licence (a) if it could find that doing so would be in the public interest, and (b) if it is able to meet its statutory obligations, including its obligations in respect of setting just and reasonable payment amounts that provide for a fair return to OPG. In making such a licensing decision, the OEB would also have to consider that the IESO's obligations under Section 78.1 exist independent of and are outside the scope of the licence from the OEB.

II. BACKGROUND

A. Regulatory Assets and International Financial Reporting Standards

The OEB sets the requirements that regulated utilities in Ontario must meet for *regulatory* accounting, reporting and filing purposes. The Canadian Accounting Standards Board and other standard-setting bodies set the accounting principles required for *financial* reporting. Regulated utilities have separate obligations to adhere to both regulatory accounting and financial accounting requirements. The Canadian Accounting Standards Board has required

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[2] *Supra* Note 1.

[3] *Supra* Note 1.

that Canadian Generally Accepted Accounting Principles ("CGAAP") for publicly accountable enterprises transition to IFRS. Although this transition is generally effective January 1, 2011, a one year deferral in implementation of IFRS is available to eligible rate-regulated enterprises. It is our understanding that OPG is eligible for and has elected to apply this one-year deferral.

The transition to IFRS has raised a variety of issues and concerns for the OEB and rate-regulated utilities in Ontario, as well as for economic regulators and utilities in other Canadian jurisdictions. One significant concern relates to the recognition of regulatory assets and liabilities. As will be described further below, regulatory assets and liabilities arise from positive or negative balances, respectively, in deferral or variance accounts.

It is our understanding that, under CGAAP for publicly accountable enterprises in effect prior to IFRS conversion, regulated entities are permitted to record regulatory assets and liabilities either pursuant to specific guidance issued by the Canadian Accounting Standards Board or as a result of their ability to refer to the specific guidance issued by the Financial Accounting Standards Board in the United States (e.g., Codification Topic 980, *Accounting for the Effects of Certain Types of Regulation*, formerly Financial Accounting Standards No. 71). Under IFRS, there is no specific guidance related to accounting for the effects of rate regulation. As a result, we further understand that the recognition of regulatory assets and liabilities for financial reporting purposes continues to be the subject of discussion and debate among affected utilities, accounting firms and the International Accounting Standards Board ("IASB").

The application of the recognition criteria under IFRS to amounts that are currently being reported by OPG and other regulated utilities as regulatory assets and liabilities under CGAAP is a matter that is strictly for the consideration of accounting experts. However, it is against this background that the balance of this memorandum considers the legal rights and obligations of OPG to recover from or disburse to ratepayers the balances in its deferral and variance accounts under current conditions, as well as in circumstances where OPG ceases operations and does not have any energy output from its prescribed facilities.

III. LEGISLATIVE FRAMEWORK

A. Jurisdiction of the OEB

In Ontario, the OEB is established under the OEB Act as an administrative tribunal responsible for the regulation and supervision of the natural gas and electricity industries. The OEB derives its powers from the Ontario Legislature primarily under the OEB Act and the *Electricity Act, 1998* (the "Electricity Act"), including regulations thereunder, and is further governed by the *Statutory Powers Procedures Act* ("SPPA"). In addition to its legislative sources of power, jurisdiction for the OEB arises from the doctrine of jurisdiction by necessary implication, under which the powers conferred by an enabling statute are construed to include not only those powers that are expressly granted but also, by implication, all powers which are practically necessary for the accomplishment of the object intended to be secured by the statutory regime.[3]

[3] David M. Brown, *Energy Regulation in Ontario*, Chapter. 2 "OEB Structure, Powers and Jurisdiction" at para 2:30:30; Ruth Sullivan, *Sullivan on the Construction of Statutes* (5th ed.), LexisNexis Canada Inc. 2008 at p. 184.

B. Setting Rates and Payment Amounts

The OEB's jurisdiction to set rates or payment amounts arises from Section 36 of the OEB Act in respect of gas transmission, distribution and storage rates, from Section 78 of the OEB Act in respect of electricity transmission and distribution rates and, of particular relevance to OPG, from Section 78.1 of the OEB Act in respect of payment amounts for prescribed electricity generation. Section 78.1 states (emphasis added):

Payments to prescribed generator

78.1 (1) The IESO shall make payments to a generator prescribed by the regulations, or to the OPA on behalf of a generator prescribed by the regulations, with respect to output that is generated by a unit at a generation facility prescribed by the regulations.

Payment amount

(2) Each payment referred to in subsection (1) shall be the amount determined,

(a) in accordance with the regulations to the extent the payment relates to a period that is on or after the day this section comes into force and before the later of,

(i) the day prescribed for the purposes of this subsection, and

(ii) the effective date of the Board's first order in respect of the generator; and

(b) in accordance with the order of the Board then in effect to the extent the payment relates to a period that is on or after the later of,

(i) the day prescribed for the purposes of this subsection, and

(ii) the effective date of the Board's first order under this section in respect of the generator.

OPA may act as settlement agent

(3) The OPA may act as a settlement agent to settle amounts payable to a generator under this section.

Board orders

(4) The Board shall make an order under this section in accordance with the rules prescribed by the regulations and may include in the order conditions, classifications or practices, including rules respecting the calculation of the amount of the payment.

Fixing other prices

(5) The Board may fix such other payment amounts as it finds to be just and reasonable,

(a) on an application for an order under this section, if the Board is not satisfied that the amount applied for is just and reasonable; or

(b) at any other time, if the Board is not satisfied that the current payment amount is just and reasonable.

Burden of proof

(6) Subject to subsection (7), the burden of proof is on the applicant in an application made under this section.

Order

(7) If the Board on its own motion or at the request of the Minister commences a proceeding to determine whether an amount that the Board may approve or fix under this section is just and reasonable,

(a) the burden of establishing that the amount is just and reasonable is on the generator; and

(b) the Board shall make an order approving or fixing an amount that is just and reasonable.

Application

(8) Subsections (4), (5) and (7) apply only on and after the day prescribed by the regulations for the purposes of subsection (2).

For purposes of Subsection 78.1(1), Section 1 of O. Reg. 53/05 establishes that OPG is a "prescribed generator" and Section 2 of O. Reg. 53/05 establishes that the "prescribed generation facilities" are comprised of the five hydroelectric generating stations in OPG's Niagara Plant Group, the R. H. Saunders hydroelectric generating station, the Pickering 'A' and 'B' Nuclear Generating Stations and the Darlington Nuclear Generating Station.

Subsection 78.1(2)(b) requires that each such payment made to OPG by the IESO shall be in accordance with the order of the OEB then in effect. The OEB is required under Subsection 78.1(4) to make such orders in accordance with the rules prescribed by the regulations, most importantly O. Reg. 53/05, and, in discharging its responsibility, include in such orders conditions, classifications or practices, including in respect of the calculation of the payment amount. As part of this jurisdiction, the OEB has the ability to authorize variance and deferral accounts as part of the OEB's rate setting powers.

Under Subsection 78.1(5) the OEB may fix such other payment amounts (i.e. payment amounts other than those arising from Subsection 78.1(4)) as it finds to be just and reasonable in circumstances where either the payment amount applied for is not just and reasonable, or if it finds the current payment amount to be unjust and unreasonable. In either circumstance, where the OEB establishes such other payment amounts, these other payment amounts must be established in accordance with the just and reasonable standard. This is consistent with the setting of rates under Sections 36 and 78 of the OEB Act, where the OEB's determination of payment amounts is on the basis of the "just and reasonable" standard. The Supreme Court of Canada has described just and reasonable rates as "rates, which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested."[5] These two components of the just and reasonable standard - that rates be fair to the consumer and yield fair compensation to the utility and its owner - are also embodied in the OEB's objects regarding the regulation of

[5] *Northwestern Utilities Ltd. v. Edmonton (City), Board of Public Utility Commissioners of Alberta*, [1929] 2 D.L.R. 4, [1929] S.C.R. 186 at p. 192-193.

electricity, namely through its objectives of protecting consumer interests and facilitating a financially viable electricity industry.[6]

Fair compensation to the utility is comprised of two elements: (1) the right to recover all prudently incurred costs, and (2) the right to a fair return on invested capital. With respect to prudently incurred costs, the Ontario Divisional Court has held that a utility has a right to recover its prudently incurred costs, as follows:

> Essentially, a utility is entitled to recover its prudently incurred costs . . . Expenditures are deemed to be prudent, in the absence of some evidence suggesting the contrary. However, costs that are found to be dishonestly incurred, or which are negligent or wasteful losses, are excluded from the legitimate operating costs of the utility in determining rates that may be charged. The examination of whether an expenditure was prudent must be based on the particular circumstances at the time the decision to incur those costs was made. That is so even if in hindsight it is obvious the decision was a bad one.[7]

It is clear that this presumption of prudence applies in circumstances where the OEB is carrying out an after-the-fact prudence review, such as would be the case for a review that is undertaken for the purpose of determining whether to allow recovery of amounts previously recorded in a deferral or variance account.[8]

With respect to the right to a fair return, the Supreme Court of Canada explains that "by a fair return (it) is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise."[9] Allowing a utility to earn a fair return has been regarded as essential to the preservation of the financial integrity of a utility, which is of mutual concern to the utility and its customers.[10]

C. Variance and Deferral Accounts

Variance and deferral accounts are tools that the OEB uses to deal with uncertainty, including circumstances that are difficult to forecast and that may be beyond the control of the regulated utility. The use of these accounts protects the interests not only of utilities, but also the interests of ratepayers. Once the deferral or variance accounts are established, either by regulation or OEB order, the amounts recorded in the accounts must be assessed for prudence by the OEB (to the extent the OEB has jurisdiction to do so) and the resulting approved amounts must be paid to or by OPG as the amounts are a part of OPG's just and reasonable payment amounts, as explained above.

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[6] OEB Act, s. 1(1).

[7] *Enbridge Gas Distribution Inc. v. Ontario Energy Board* (2005), 75 O.R. (3d) 72 (Div. Ct.); rev'd on other grounds, (2006), 41 Admin L.R. (4th) 69.

[8] Ontario Energy Board, *Decision With Reasons - Application by Ontario Power Generation Inc. for Payment Amounts for Prescribed Facilities for 2011 and 2012 (EB-2010-0008)*, March 10, 2011 at p. 19.

[9] *Supra* note 5 at p. 193.

[10] *Union Gas Ltd. v. Ontario (Energy Board)* (1983), 1 D.L.R. (4th) 698 (Ont. Div. Ct.) at p. 711, as cited in Brown, *supra* note 4 at 2:40:10.

A "variance account" may be used to track underestimates or overestimates of specific costs or revenues so as to enable the amount of the variance to be disposed of, normally through higher or lower payment amounts established by the OEB in the future. For example, recognizing the uncertainties associated with fluctuating world uranium prices and with a view to protecting OPG and ratepayers, the OEB approved OPG's request in EB-2007-0905 to establish a variance account to capture the differences between forecast and actual nuclear fuel expenses. In this way, if OPG's actual fuel costs proved to be higher than its forecasted costs then OPG would be entitled in the future to receive the shortfall from ratepayers, provided that the shortfall was a result of prudent actions by OPG and has been accurately recorded in the account. Alternatively, if OPG's actual fuel costs proved to be lower than its forecasted costs, then OPG would have over-recovered and would be required by the OEB to disburse such amounts back to ratepayers, subject to the review for prudence and accuracy.

A "deferral account" may be used, for example, to track specific costs incurred by a utility with respect to a project or circumstance until a future date, after which the costs recorded in the account are subject to prudence review by the OEB before the utility will be allowed to begin recovering those costs from ratepayers. For example, O. Reg. 53/05 authorized OPG to establish a deferral account to record non-capital costs associated with a large nuclear project that involved the return-to-service of certain nuclear generating units. The regulation further required that the OEB ensure OPG recover the balance in the account over a certain period of time, which the OEB determined in EB-2007-0905.

The nature of the rights that arise from the authorization of a deferral or variance account by the OEB or under O. Reg. 53/05 are discussed in the analysis section, below. For accounts that have already been authorized, as part of the OEB's rate-setting function and its powers with respect to variance and deferral accounts, the OEB will periodically[11] review a utility's variance and deferral accounts to ensure that the balances reflect amounts that are prudent and have been accurately recorded. Based on such review, the OEB makes a determination as to how much of the recorded balance the utility will recover (or repay) and the period over which such amount shall be recovered (or repaid). This determination will be made by way of a Decision from the OEB. In the normal course (i.e. where the accounts are reviewed in the context of a rate or payment amount application), the utility will then be required to file a draft payment amounts order or draft rate order, which is reviewed by the OEB. Once the final payment amounts order or rate order is approved by the OEB, the IESO will be required to implement the order by paying OPG in accordance with the order.

Where the balance recorded in a variance or deferral account is in a debit position and the OEB has accepted that balance as reflecting costs prudently incurred and accurately recorded, this will be referred to as a "regulatory asset" and will represent the specific amount that the utility will have a right to recover in such manner as is ordered by the OEB. Similarly, where the balance recorded in a variance or deferral account is in a credit position and the OEB has accepted that balance as reflecting costs prudently incurred and accurately recorded, this will be referred to as a "regulatory liability" and will represent the specific amount that the utility will have an obligation to disburse in such manner as is ordered by the OEB.

For the analysis in Section IV below, it is important to set out in some detail the legal origins of OPG's variance and deferral accounts.

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[11] While normally this will be in the context of a rate or payment amount application, OPG could apply to have the OEB undertake such a review at any time through a separate proceeding. Similarly, the OEB has the right to undertake such a review at any time on its own motion. See s. 78.1(5) of the *OEB Act*.

Transitional Accounts

Under O. Reg. 53/05, OPG was required to establish five variance accounts and three deferral accounts in the years prior to OPG's first application to the OEB for determination of payment amounts under Section 78.1 of the OEB Act (the "Transitional Accounts"). OPG recorded amounts in the Transitional Accounts *up to* the effective date of the OEB's first payment amounts order, which was April 1, 2008. The OEB considered the balances accrued in the Transitional Accounts during the course of hearing OPG's first application under Section 78.1 (EB-2007-0905) and determined the amount for each account, recorded up to December 31, 2007, that OPG would be able to recover or would be obligated to repay.[12] The OEB allowed recovery or obligated repayment of these amounts over periods of approximately two, three or four years, depending on the account.

Mandated Continuing Accounts

Under O. Reg. 53/05, OPG was also required to establish one variance account and two deferral accounts which were to be substantially the same as three of the Transition Accounts, but which were for purposes of capturing certain costs incurred *on and after* the effective date of the OEB's first order under Section 78.1 (the "Mandated Continuing Accounts"). OPG continues to be required under O. Reg. 53/05 to keep and track amounts in each of these Mandated Continuing Accounts. The Mandated Continuing Accounts are:

- Section 5(4) - Pickering 'A' Return to Service Deferral Account
- Section 5.2 - Nuclear Liability Deferral Account
- Section 5.4 - Nuclear Development Variance Account

Board Ordered Continuing Accounts

In addition to the Mandated Continuing Accounts, in EB-2007-0905 OPG requested that the OEB authorize the continuation on and after the effective date of the OEB's first order under Section 78.1 of three variance accounts that had been required under O. Reg. 53/05, but for which the regulation did not mandate their continuation beyond the effective date of the OEB's first order (the "Board Ordered Continuing Accounts"). The Board accepted OPG's proposal for the Board Ordered Continuing Accounts, which are:

- Hydroelectric Water Conditions Variance Account
- Ancillary Services Net Revenue Variance Account
- Capacity Refurbishment Variance Account[13]

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[12] Amounts recorded in the Transitional Accounts between January 1, 2007 and March 31, 2008 were considered in EB-2010-0008.

[13] Though not expressly required under O. Reg 53/05, the Board found that the Capacity Refurbishment Variance Account is implicitly required due to the obligation in s. 6(2)4 of the regulation. See *Infra* note 16 at pp. 122-123.

Board Ordered Accounts

Although not expressly mandated by O. Reg. 53/05, the Board determined in its Decision in EB-2007-0905 that it was necessary to give effect to certain provisions of O. Reg. 53/05 that continue to apply on and after the effective date of the OEB's first order. As a result, the OEB authorized OPG to establish the:

- Bruce Lease Net Revenues Variance Account

Another category of accounts arising from the Board's first order under Section 78.1 are new accounts that had not been required at any time under O. Reg. 53/05, but which OPG requested and the OEB approved of in its Decision in EB-2007-0905 (the "Board Ordered Accounts"). In addition to the account above, included in this category are the following variance accounts also approved by the Board:

- Nuclear Fuel Cost Variance Account
- Income and Other Taxes Variance Account
- Hydroelectric Interim Period Shortfall Variance Account
- Nuclear Interim Period Shortfall Variance Account

During a related proceeding (EB-2009-0038) arising from EB-2007-0905, the Board also approved the following:

- Tax Loss Variance Account

In EB-2009-0174, a proceeding dealing with the manner of calculating entries into the deferral and variance accounts after December 31, 2009 until the effective date of the next payment amounts order for OPG, the OEB also established two additional accounts:

- Hydroelectric Deferral and Variance Over/Under Recovery Variance Account
- Nuclear Deferral and Variance Over/Under Recovery Variance Account

In EB-2010-0008, OPG applied for new payment amounts for the 2011 to 2012 period. In its Decision with Reasons dated March 10, 2011, the OEB approved the continuation of existing hydroelectric accounts, nuclear accounts and accounts common to both the regulated hydroelectric and nuclear businesses as proposed by OPG, as well as two new hydroelectric accounts.[14] OPG's accounts for 2011 and 2012 are therefore as follows:

- Existing Common Accounts:
    - Ancillary Services Net Revenue Variance Account

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[14] *Supra* Note 8 at pp. 128-142. On March 30, 2011 OPG filed a Notice of Motion to review and vary the Decision and Order, in which OPG requested the establishment of a Pension and Other Post Employment Benefits Cost Variance Account. The Motion proceeding is in progress.

    - Income and Other Taxes Variance Account
    - Tax Loss Variance Account
- Existing Hydroelectric Accounts:
    - Hydroelectric Water Conditions Variance Account
    - Hydroelectric Deferral and Variance Over/Under Recovery Variance Account
- Existing Nuclear Accounts:
    - Nuclear Liability Deferral Account (Section 5.2)
    - Nuclear Development Variance Account (Section 5.4)
    - Capacity Refurbishment Variance Account
    - Nuclear Fuel Cost Variance Account
    - Bruce Lease Net Revenues Variance Account
    - Nuclear Deferral and Variance Over/Under Recovery Variance Account
- Existing Accounts to be Continued for Recording of Amortization and Interest Amounts Only and to be Closed Upon Balances Being Recovered:
    - Hydroelectric Interim Period Shortfall Variance Account
    - Pickering 'A' Return to Service Deferral Account (Section 5(4))
    - Transmission Outages and Restrictions Variance Account
    - Nuclear Interim Period Shortfall Variance Account
- New Hydroelectric Accounts:
    - Surplus Baseload Generation (Hydroelectric)
    - Hydroelectric Incentive Mechanism

IV. ANALYSIS

A. Legal Basis for OPG's Regulatory Deferral and Variance Accounts

The legal basis for OPG's regulatory deferral and variance accounts must be considered in the context of the regulatory cycle that OPG is subject to as a rate-regulated utility, as described below.

As with other rate-regulated entities, OPG may apply to the OEB or the OEB may require OPG to apply for new payment amounts from time to time. The OEB then holds an adversarial hearing to consider the application, during which the application is subject to rigorous review and scrutiny by OEB staff members, intervening parties and the OEB panel itself. After considering the evidence and arguments presented, the OEB panel issues a Decision setting out the panel's findings with respect to each of the aspects of the application, including the various requests for cost recovery that normally comprise such an application. The Decision will also set out the OEB panel's determinations with respect to any proposed new deferral or variance accounts, the continuation of existing accounts, and the specific amounts that may be recovered with respect to the balances previously recorded in the existing accounts.

With respect to any new deferral or variance accounts that an applicant *proposes* to establish, the panel of the OEB will make a determination as to whether the applicant shall be permitted to establish such accounts and record amounts in that account. Based on OEB practice, this will generally depend upon whether the OEB is persuaded that the proposed account satisfies the criteria of causation, materiality, management inability to control and prudence. In this context, "causation" refers to the requirement that the amounts to be recorded in the proposed account must be outside of the basis upon which rates will derived for the applicable period; "materiality" refers to the requirement that the amounts expected to be recorded in the proposed account will significantly influence the operation of the regulated business; "management inability to control" refers to the requirement that there be uncertainty associated with the amounts that are expected to be recorded in the account and, due to this uncertainty such amounts are not easily predictable and not easily controlled by the utility's management; and "prudence" refers to the need for the amounts recorded to have been prudently incurred.

If approval to establish a new account is granted by the OEB, then the utility will be obligated to accurately record relevant amounts in the account for the applicable period with the presumption that the balance of the account is accurately recorded and prudently incurred, such that it will be recoverable, subject to review by the Board for the purpose of verifying the presumption. The OEB will then need to conduct a prudence review that will normally, but not necessarily, take place in the course of reviewing a subsequent application for new payment amounts or rates by the utility.

With respect to each *existing* deferral and variance account, the panel will make findings as to whether the amounts recorded in the account have been accurately recorded and whether they are prudent. Based on these findings, the panel will determine how much the utility will recover from or return to ratepayers in respect of each account. The amounts recoverable from deferral and variance accounts may be recovered through one or more separate rate riders or through such other means as the Board approves. The rate mechanism for recovery of amounts from ratepayers or for repayment of amounts to ratepayers, as set out by the OEB, does not alter or limit OPG's right to receive or obligation to disburse prudent and accurately recorded amounts in the accounts.

The prudence review would apply the established regulatory principles referred to earlier, namely, that:

- Amounts will be deemed to be prudent in the absence of reasonable grounds to suggest the contrary;
- Costs that are found to have been dishonestly incurred, or which are negligent or wasteful losses, may be excluded from recovery; and

- The examination of prudence must be carried out without the benefit of hindsight (i.e. based on the particular circumstances at the time the decision to incur those costs was made).

1. Deferral and Variance Account Balances Pending OEB Review

OPG's legal rights in respect of its deferral and variance accounts must be considered in respect of the forgoing.

The circumstance of OPG having account balances pending OEB review arises where pursuant to an Order in a prior proceeding before the OEB, or under O. Reg. 53/05, OPG has been authorized to establish and record amounts in a deferral or variance account, either for a particular period or until such time as the OEB orders otherwise, but the period has not expired or there has not been a subsequent OEB order. While OPG will have recorded amounts in the account during that period of time, the OEB will not yet have reviewed the balances in the accounts to determine if they reflect accurately recorded and prudent amounts. The critical issue in this scenario relates to the nature of the rights conferred on OPG by the granting of approval to establish a deferral or variance account. Where the Board authorizes OPG to establish such an account or if the account is established by regulation, OPG will have acquired a right to record amounts in such an account. These amounts, when recorded, will reflect costs that have been incurred or revenue earned by OPG for the benefit of ratepayers.

Pursuant to established principles governing the Board's obligation to review the prudence of recorded expenditures prior to allowing for their recovery, as discussed above, the expenditures recorded in the account are deemed to have been prudently incurred in the absence of reasonable grounds to suggest the contrary. As such, in our view, the granting of approval to establish a deferral or variance account confers upon OPG a legal right to record amounts in the account and to account for the amounts recorded on the basis that they have been prudently incurred. Courts have found that prudence is deemed to exist until such time as the OEB (in its discretion) may, at a later date, value or assess the balance of that account and determine that the recorded balance is wholly recoverable or that certain of the recorded amounts have in fact not been prudently incurred and are not recoverable. This subsequent assessment of prudence by the Board will therefore only have the effect of confirming or altering the specific amount that shall be recovered or that must be repaid by OPG in respect of the account. The prudence review will not affect the right to record amounts or the recovery of prudently incurred amounts.

We note that any amounts recorded in approved deferral and variance accounts must ultimately be disposed of by the OEB, whether done pursuant to an application brought to the OEB or by the OEB on its own motion. This arises from the OEB's obligation to set just and reasonable rates and payment amounts.[15]

While the focus of discussion in this section has thus far been on the rights associated with deferral and variance accounts that have been established through orders of the OEB, it is important to recognize the specific rights associated with each of OPG's accounts that arise by operation of O. Reg. 53/05.

The Mandated Continuing Accounts are clearly different from the rest of OPG's accounts because, rather than having been established on the basis of an order issued by the Board, OPG

[15] *Dow Chemical Canada Inc. v. Union Gas Ltd.* (1982), 141 D.L.R. (3d) 641 at pp. 658-9 (Ont. H.C.J.), affirmed 150 D.L.R. (3d) 267 (C.A.).

is required under O. Reg. 53/05 to have established and to maintain from the effective date of the OEB's first order under Section 78.1 of the OEB Act each of the three Mandated Continuing Accounts. OPG thereby acquired its rights resulting from the establishment of these accounts by way of regulation. As such, the OEB has no discretion with respect to the continuation of these accounts.

Moreover, for two of the Mandated Continuing Accounts, it appears that the OEB has no jurisdiction to undertake prudence reviews. These accounts - the Pickering 'A' Return to Service Deferral Account and the Nuclear Liability Deferral Account - are established on the same basis as accounts for which the OEB determined in EB-2007-0905 that it has no discretion to evaluate prudence.[16]

For the Pickering 'A' Return to Service Deferral Account, paragraph 6(2) 3 of O. Reg. 53/05 requires the OEB to ensure that OPG recovers the balance recorded in the deferral account established under subsection 5(4), which requires OPG to establish a deferral account that records certain costs associated with the planned return to service of all units at the Pickering 'A' Nuclear Generating Station. Subsection 5(4) gave rise to a Transitional Account, as well as a Mandated Continuing Account.[17] For the Nuclear Liability Deferral Account, paragraph 6(2)7 of O. Reg. 53/05 requires the OEB to ensure that OPG recovers the balances recorded in the deferral accounts established under subsections 5.1(1) and 5.2(1). These subsections each require OPG to establish a deferral account to record the revenue requirement impacts of changes in its nuclear decommissioning liability, however 5.1(1) applies to the period prior to the OEB's first order and is therefore a Transitional Account while 5.2(1) applies to the period following the OEB's first order and is therefore a Mandated Continuing Account.[18] Based on the OEB's findings in EB-2007-0905 that it had no discretion to evaluate prudence with respect to the Transitional Accounts under subsections 5(4) and 5.1(1), it appears that the Board would similarly have no discretion to evaluate prudence with respect to the Mandated Continuing Accounts established under subsections 5(4) and 5.2(1) of O. Reg. 53/05.

For the Capacity Refurbishment Variance Account, which is a Board Ordered Continuing Account, the OEB notes in its Decision in EB-2007-0905 that this account is required in light of the obligation imposed on the Board by paragraph 6(2)4 of O. Reg. 53/05.[19] Under 6(2)4, the Board is required to ensure that OPG recovers the amounts recorded in this account. If such amounts were within project budgets approved by OPG's Board of Directors prior to the Board's first order under Section 78.1 but where such costs were actually incurred and recorded in the account subsequent to the Board's first order, then it appears based on a reading of 6(2)4 that an argument could be made that the OEB would have no jurisdiction to evaluate prudence. However, if the amounts were not approved by OPG's Board of Directors prior to the first order of the Board, then this argument would not be available.

Finally, special consideration should be given to the Bruce Lease Net Revenues Variance Account. As noted earlier, this account was not expressly mandated by O. Reg. 53/05 but in its Decision the Board determined that it was necessary for OPG to establish this account in order

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[16] Ontario Energy Board, *Decision With Reasons - Application by Ontario Power Generation Inc. for Payment Amounts for Prescribed Facilities (EB-2007-0905)*, November 3, 2008 at p. 9.

[17] Ibid at p. 122.

[18] Ibid.

[19] Ibid at p. 123.

to give effect to certain provisions of O. Reg. 53/05.[20] In particular, the Board directed OPG to establish this account in order to give effect to paragraphs 6(2)9 and 6(2)10 of the regulation. Paragraph 6(2)9 requires the OEB to ensure that OPG recovers all of the costs it incurs with respect to the Bruce Nuclear Generating Stations. Paragraph 6(2)10 provides that if OPG's revenues earned from the Bruce Nuclear Generating Stations exceed OPG's costs in respect of those stations, then the excess shall be applied to reduce OPG's revenue requirement for purposes of the payment amounts under Section 78.1(1) of the OEB Act. Based on its findings in EB-2007-0905, it seems that the Board will be obligated to require that OPG maintain this account for so long as it leases the Bruce Nuclear Generating Stations. In addition, based on paragraph 6(2)9, which does not expressly require the OEB to undertake a prudence review, it appears that an argument could be made that the OEB does not have jurisdiction to carry out a prudence review of costs recorded in this account.

In summary, OPG acquires rights, as described above, in connection with its deferral and variance accounts, either from O. Reg. 53/05 or from the granting of approval by the OEB to establish such accounts. For some of the accounts established under O. Reg. 53/05, it appears that the OEB has no discretion with respect to their continuation. Moreover, for certain of the accounts established under O. Reg. 53/05, as discussed, the OEB has no jurisdiction to evaluate the prudence of recorded amounts.

2. Deferral and Variance Account Balances Approved for Incorporation into Payment Amounts

In the scenario being considered here, OPG has in a prior proceeding or by way of O. Reg. 53/05 been authorized to establish a deferral or variance account. OPG has recorded amounts in the account over the applicable period and it has applied to the OEB, as part of a comprehensive application to determine new payment amounts for its regulated facilities or through a separate proceeding, to dispose of the balance of that account as of a particular date. The OEB has reviewed the balance of the account to ensure that it reflects amounts that are prudent and accurately recorded. Based on its review, the OEB has determined a specific amount as being the balance of the account and has also given approval for OPG to recover that amount over a particular period.

Further to the rights conferred upon OPG on being authorized to establish the account, as described in the previous section, in this scenario, as a result of the OEB having carried out the prudency review (where it has the jurisdiction to do so) and issued its Decision, the specific balance for the account that OPG will be allowed to recover will have been established. Based upon the law set out above, OPG will have a legal right to recover (or legal obligation to repay) that balance, pursuant to a payment amounts order issued by the OEB and the IESO will be required to recover the balance and remit it to OPG (or recover the balance from OPG and repay it to consumers) in accordance with the OEB's order.

B. Regulatory Assets in the Absence of Future Services

As noted, you have asked us to consider whether deferral and variance account balances are recoverable (or payable) in a circumstance where OPG ceases operations and does not have any energy output from its prescribed facilities. Our consideration of this issue is set out below.

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[20] Ibid at p. 112.

It is our opinion based on the analysis below, that the OEB has both the obligation and the jurisdiction to establish a rate or payment amount that would allow OPG to recover prudently incurred and accurately recorded amounts recorded in a deferral or variance account notwithstanding that OPG produces no output. The OEB's obligations with respect to reviewing and disposing of the balances recorded in the accounts are not altered by the fact that there is no future output, as the amounts recorded in the accounts are part of the OEB's determination of "just and reasonable" rates or payment amounts.

A circumstance where there is no output would imply that the current volumetric rate through which OPG recovers costs (dollars per MWh produced) would not permit recovery of costs. As a result, an alternative rate formulation with a fixed charge or a volumetric rate recoverable from energy consumed, rather than produced, would have to be implemented to recover costs prudently incurred, including amounts recorded in variance and deferral accounts. Therefore, the question is whether the OEB can establish a rate or payment amount that is not based on dollars per output and would permit recovery of deferral or variance account balances.

As noted above, whether an expenditure is prudent must be based on the particular circumstances at the time the decision to incur the cost was made.[21] As deferral and variance account balances reflect costs previously incurred or revenues previously earned, it is reasonable to conclude that, based upon a set of facts, once these costs or revenues have been found to be prudent by the OEB, then they will remain prudent and recoverable irrespective of the lack of future output. Likewise, for amounts recorded in a deferral or variance account established by the OEB or under O. Reg. 53/05, but not yet assessed as to whether they are prudent, the amounts recorded are presumed at law to have resulted from prudent actions, unless shown to be otherwise. As discussed above, the Board has the obligation to establish just and reasonable rates, which includes the establishment of deferral and variance accounts and their subsequent disposition. If the Board has the power to direct the segregation of expenditures pending a rate application, it must by necessary implication have the power to direct the applicant to deal with the amounts so separated in a future rate application. Courts have found that:

> It cannot reasonably be presumed that the legislature intended to so truncate the Board's jurisdiction so as to allow it to accomplish only a partial result, with no power to finalize and complete a regulatory order. When legislation attempts to create a comprehensive regulatory framework, the tribunal must have the powers which by practical necessity and necessary implication flow from the regulatory authority explicitly conferred upon it.[22]

The OEB has both the jurisdiction and the obligation to establish a rate or payment amount that allows OPG to recover such prudently incurred amounts in the event that there is no output by OPG's prescribed facilities. The OEB also has jurisdiction to set payment amounts on a non-volumetric basis. Based on Subsections 78.1(4) and (5) of the OEB Act, as well as from section 6(1) of O. Reg. 53/05, the OEB has broad jurisdiction in the setting of payment amounts for OPG's regulated facilities, including the power to set payment amounts on a non-volumetric basis so long as such amounts are consistent with the just and reasonable standard. These provisions are as follows:

- Section 78.1(4) provides that "the Board shall make an order under this section in accordance with the rules prescribed by the regulations and may include in the

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[21] *Supra* note 7.

[22] *Supra* note 15.

order conditions, classifications or practices, including rules respecting the calculation of the amount of the payment. (emphasis added)

- Section 78.1(5) provides that "the Board may fix such other payment amounts as it finds to be just and reasonable, (a) on an application for an order under this section, if the Board is not satisfied that the amount applied for is just and reasonable; or (b) at any other time, if the Board is not satisfied that the current payment amount is just and reasonable. (emphasis added)

- Section 6(1) of O. Reg. 53/05 states that "Subject to subsection (2), the Board may establish the form, methodology, assumptions and calculations used in making an order that determines payment amounts for the purpose of section 78.1 of the Act." (emphasis added)

Therefore, based on the foregoing, the OEB's obligations are twofold. First, the legislature has imposed on the OEB an obligation - pursuant to section 78.1(4) - when making a payment amount order for OPG to follow the rules prescribed by the regulations. Second, the legislature has imposed on the OEB an obligation - pursuant to section 78.1(5)(a) - to set just and reasonable payment amounts in respect of amounts that do not arise from section 78.1(4). More specifically, under section 78.1(4), the OEB is required to make its payment amount order for OPG in accordance with the provisions set out in O. Reg. 53/05. To the extent that there are payment amounts associated with the prescribed facilities but which are outside the scope of O. Reg. 53/05, pursuant to section 78.1(5) the OEB is permitted to establish such other payments so long as those other payment amounts are found to be just and reasonable. The OEB has the authority to establish such other just and reasonable payment amounts either on an application for an order under section 78.1 or at any other time on the OEB's own motion.

Various utilities in Ontario have from time to time levied OEB-approved fixed charges. The OEB has jurisdiction to establish a rate or payment amount permitting the recovery by OPG of a fixed charge if the charge is just and reasonable.

Under the legislative scheme the OEB has jurisdiction to establish the rate or payment amount pursuant to Section 78.1 of the OEB Act. The IESO has the obligation to pay that rate or payment amount to OPG and is subject to the OEB's authority to set the payment amount. Subsection 78.1(2) provides as follows:

> Each payment referred to in Subsection (1) shall be the amount determined, ...
>
> (b) In accordance with the order of the Board then in effect to the extent that payment relates to a period that is on or after the later of,
>
> (i) the date prescribed for the purposes of this subsection, and
>
> (ii) the effective date of the Board's first order under this section in respect of the generator." (emphasis added)

The reference to subsection (1) in Subsection 78.1(2) is in regard to the provision which states:

> The IESO shall make payments to a generator prescribed by the regulations... with respect to output that is generated by a unit at a generation facility prescribed by the regulations. (emphasis added)

We note that Subsection 78.1(1) makes reference to payments to a generator "with respect to output that is generated." However, this language does not imply that the rate or payment amount is to be limited to a volumetric payment on the basis of dollars per MWh produced.

The modern principle of statutory interpretation states that "the words of an act are to be read in their entire context, in their grammatical and ordinary sense harmoniously with the scheme of the act, the object of the act and the intention of parliament."[23] On this basis, in regard to the judicial interpretation of the words "with respect to" found in Subsection 78.1(1), these words have been interpreted to have a similar meaning as terms such as "in relation to", "with reference to" or "in connection with".[24] In *Markevich v. Canada*, Major J. of the Supreme Court of Canada wrote:

> The words "in respect of" have been held by this Court to be words of the broadest scope that convey some link between two subject matters. See *Nowegijick v. The Queen*, [1983] 1 S.C.R. 29, at p. 39, per Dickson J. (as he then was):
>
>> The words "in respect of" are, in my opinion, words of the widest possible scope. They import such meanings as "in relation to", "with reference to" or "in connection with". The phrase "in respect of" is probably the widest of any expression intended to convey some connection between two related subject matters.[25]

As a result, a court would likely interpret Subsection 78.1(1) to mean that the IESO must make payments to OPG that have some connection with output that is generated by the units at OPG's regulated facilities. Payment amounts related to deferral and variance accounts recovered during periods where there are no outputs fit within this interpretation as those balances reflect or have some connection with past output from the prescribed facilities.

In addition, this interpretation is consistent with the presumption, in the interpretation of statutes, against internal conflict. Sullivan in her authoritative text states:

> The parts are presumed to fit together logically to form a rational, internally consistent framework; and because the framework has a purpose, the parts are also presumed to work together dynamically, each contributing something toward accomplishing the intended goal. This presumption is the basis for analyzing legislative schemes, which is often the most persuasive form of analysis. The presumption of coherence is also expressed as a presumption against internal conflict. It is presumed that the body of legislation enacted by a legislature does not contain contradictions or inconsistencies . . .[26]

It is internally consistent to interpret the legislative scheme of Section 78.1 as imposing upon the OEB the obligation to set rates or payment amounts in the manner described above, including the obligation to authorize the recovery of deferral and variance account balances, with full and broad powers to do so and imposing upon the IESO the responsibility for paying to OPG the payment amounts prescribed by the Board's order. In the circumstance where there is no

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[23] Elmer A. Driedger, *The Construction of Statutes* (Toronto: Butterworths, 1974) , at p. 67, as cited in Sullivan, *Supra* note 4 at p. 1.

[24] *Skelly v. Assist Realty Ltd.*, (1991), 16 C.H.R.R. D/1 at D/6, 92 C.L.L.C. 17, 014 (B.C. Human Rights Council).

[25] [2003] S.C.J. No. 8, [2003] 1 S.C.R. 94 (S.C.C.).

[26] Sullivan, *Supra* note 4 at 223.

output from the prescribed facilities, such a payment amount could reflect a fixed charge or some other form of charge not on a volumetric basis for the output of the prescribed facilities so as to allow for the recovery of OPG's deferral and variance account balances.

C. Recovery of Approved Balances

Once the OEB has approved recovery of an account balance, the specific amount OPG will be entitled to recover through payment amounts is approved by the OEB. As noted, the IESO's obligation to pay that rate or payment amount to OPG is subject to the OEB's authority to set the payment amount. In this context, you have asked us to consider how OPG can be assured that the IESO will actually collect and pay those amounts to OPG. In this regard, we will consider the legal requirement for the IESO to collect the amounts on behalf of OPG and whether the IESO has effective mechanisms in place to ensure its ability to collect those amounts in full.

1. Powers and Duties of the IESO

The IESO is established under Part II of the *Electricity Act, 1998* (the "*Electricity Act*") as a corporation without share capital.[27] The business and affairs of the IESO are required by legislation to be carried out without the purpose of gain and any profits must be used by the IESO for the purpose of carrying out its objects.[28] Among other things, the IESO's statutory objects include the exercise of the powers and the performance of the duties assigned to it under the *Electricity Act*, the Market Rules and it's licence.[29]

In accordance with its objects, under the *Electricity Act*, the IESO may make rules governing the IESO controlled-grid. Such rules may include provisions, among other things, authorizing and governing the making of orders by the IESO, including orders imposing financial penalties on electricity market participants, authorizing a person to participate in the IESO-administered market, or terminating, suspending or restricting a person's rights to participate in the IESO-administered markets.[30] The rules made by the IESO under Section 32 of the *Electricity Act* are the *Market Rules for the Ontario Electricity Market* or, more commonly, the "Market Rules".[31]

With respect to the IESO's obligations under Section 5(1) of the *Electricity Act* to exercise the powers and perform the duties assigned to it under it's licence, this refers to the licence that the IESO is required to obtain and hold from the OEB in order to operate the market established by the Market Rules.[32] The IESO's current system operator licence took effect on July 31, 2008 and is currently valid until July 30, 2013.[33] By issuing the licence, the OEB authorizes the IESO to direct the operation of the transmission system in accordance with the Market Rules, applicable agreements and subject to the conditions set out in the licence.[34] The licence also authorizes the IESO to operate the IESO-administered markets and to do such things as may be permitted by the Market Rules or required to be done by the IESO to further the establishment and operation

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[27] *Electricity Act, 1998*, S.O. 1998, c. 15, Sched. A, Subsection 4(1).

[28] *Ibid.* at Subsection 5(2).

[29] *Ibid.* at Subsection 5(1).

[30] *Ibid.* at Section 32.

[31] See http://www.ieso.ca/imoweb/pubs/marketRules/mr_marketRules.pdf

[32] *Ontario Energy Board Act*, Subsection 57(h).

[33] *Independent Electricity System Operator Licence, EI-2008-0096*, Issued by the Ontario Energy Board June 26, 2008 and corrected October 23, 2008.

[34] *Ibid* at Section 3.1.

of the market.[35] Under the licence, the IESO is required to comply with all applicable provisions of the Market Rules.[36]

Consistent with its status as a not-for-profit corporation, the IESO fulfills its statutory mandate by acting as a clearinghouse to settle the flows of money between persons that are authorized to participate in the IESO-administered electricity market. To understand the flows of money in the market, it is first helpful to understand at a very basic level the flow of electricity in the market. Put simply, electricity generators provide electricity to the IESO-controlled grid. This electricity generally flows from generating stations, along transmission lines operated by transmitters, and then either to loads, such as large industrial facilities, that are directly connected to the transmission system or to distribution systems operated by local distribution companies that deliver the electricity to residential customers, small businesses and other end-users.

With respect to the flow of money in the market, distributors are responsible for collecting payments from their customers based on quantities of electricity consumed, together with any other charges that are required to be collected.[37] The IESO then receives these amounts from distributors, as well as amounts from directly connected loads. From these sources of incoming payments, the IESO is then required to ensure that distributors and transmitters receive the amounts that they are approved to receive pursuant to rates set by the OEB. The IESO must also ensure that generators are paid the amounts that they are entitled to be paid for the injection of electricity into the IESO-controlled grid.. This includes generators under contract with the OPA or Ontario Electricity Financial Corporation ("OEFC"), as well generators, namely OPG, whose payment amounts are established by order of the OEB pursuant to Section 78.1 of the OEB Act. Other than keeping the amounts that the IESO is permitted to keep in accordance with its own rate order from the OEB, which amounts cover the IESO's internal operating costs, the IESO is required to remain not-for-profit: all amounts that it receives from market participants must be paid out to such other market participants who have regulatory or contractual rights to receive payments from those collected amounts.

2. The Market Rules

The Market Rule requirements that apply to persons seeking authorization to participate in the Ontario electricity market are key to the IESO's ability to collect amounts and remit payment to OPG. In accordance with the Market Rules, no person shall participate in the IESO-administered markets unless that person has been authorized by the IESO to do so.[38] Moreover, no person shall be authorized by the IESO to be a market participant unless the IESO is satisfied:

- that the person agrees to be bound by the Market Rules by executing a participation agreement,[39]

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[35] *Ibid* at Section 3.2.

[36] *Ibid* at Section 7.1.

[37] Distributor rights and powers with respect to collection are governed by the *Distribution System Code* and the *Retail Settlement Code*, discussion of which is beyond the scope of this letter.

[38] *Market Rules*, Chapter 2, Section 1.2.1.

[39] *Ibid* at Section 1.2.2.3.

- that the person will satisfy the prudential support requirements of Appendix 2.3 of the Market Rules and any other financial requirements set forth in the Market Rules applicable to all market participants,[40] and
- that the person holds a licence from the Ontario Energy Board permitting them to, among other things, own or operate a distribution system or a transmission system, or permitting them to generate electricity for sale through the IESO-administered market, to retail electricity, to purchase electricity through the IESO-administered market, or to sell electricity through the IESO-administered market.[41]

Once satisfied that the application for participation is complete, the IESO may authorize the applicant to participate in the IESO-administered market, but only if the applicant files an executed participation agreement in such form as established by the IESO.[42] Under the participation agreement, the IESO and the market participant agree, among other things, to be bound by and to comply with the Market Rules.[43] The IESO's established form of participation agreement, which is published as part of the Market Rules, provides as follows:

> **Article 3 - Compliance with Market Rules**
>
> 3.1 **Applicant Compliance:** The Applicant hereby agrees to be bound by and to comply with all of the provisions of the market rules so far as they are applicable to the Applicant once it has been authorized by the IESO as a market participant.
>
> 3.2 **IESO Compliance:** The IESO hereby agrees to be bound by and to comply with all of the provisions of the market rules so far as they are applicable to the IESO.[44]

By virtue of Article 3, the Market Rules are effectively incorporated by reference into and therefore form part of the participation agreement. Indeed, as noted in the recitals set out in the participation agreement, "the market rules contemplate that the market rules will have the effect of a contract between each market participant and the IESO by virtue of the execution of a participation agreement."[45] As an authorized market participant, OPG has entered into a participation agreement with the IESO under which each party has agreed to be bound by and to comply with the Market Rules insofar as they are applicable to one another. Accordingly, by means of the participation agreement, the IESO is contractually obligated to pay OPG the amounts that OPG has a right to receive and, furthermore, to collect such amounts in accordance with the Market Rules in order to meet its payment obligations to OPG. Under this contractual relationship, in the event of non-payment, there would be remedies available to OPG pursuant to the dispute resolution mechanisms under the Market Rules, through the Ontario Energy Board and through the Courts.

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[40] *Ibid* at Section 1.2.2.2.

[41] *Ibid* at Section 1.2.2.4.

[42] *Ibid* at Section 3.1.5.2.

[43] *Ibid.* See also Market Rules, Chapter 11 (Definitions), "participation agreement".

[44] IESO, *Participation Agreement*, Issue 14.0, June 2, 2010.

[45] *Ibid.* at Recital 'D'.

In addition to making such authorization conditional on the filing of an executed participation agreement, the IESO's authorization is conditional upon the person satisfying the prudential support requirements set out in the Market Rules.[46]

Prudential support is financial security to cover financial obligations that a market participant might owe to the market in the event the market participant is unable to pay. Each market participant is required to meet its obligation under the Market Rules to provide and to maintain prudential support by providing to the IESO, and maintaining with the IESO, prudential support in an amount determined in accordance with the Market Rules.[47] The amount of prudential support that must be provided will reflect the market participant's maximum net exposure, less any allowable reductions, as calculated in accordance with Chapter 2 of the Market Rules.[48]

If a market participant does not make a payment in full when due, where such payment is required under the Market Rules, this will be an event of default under the Market Rules.[49] Where such an event of default has been committed by a market participant, the IESO has the right to issue a notice of intent to suspend the market participant unless it remedies the default within the specified period and to immediately draw upon part or all of the market participant's prudential support for any amount owing to the IESO.[50] The market participant may remedy the event of default by satisfying any outstanding financial or other obligations giving rise to the event of default and by satisfying the IESO that the circumstances which constituted the event of default no longer exist.[51] If the market participant has not remedied the event of default within the applicable period or due to persistent breaches of the Market Rules, the IESO may issue a suspension order to the market participant, rendering them ineligible to trade or enter into any transactions in the IESO-administered markets or to cause or permit electricity to be conveyed into, through our out of the IESO-controlled grid.[52]

Where the IESO has issued a suspension order to a defaulting market participant, the IESO has the right to issue a notice of default levy and to take any steps that it has not already taken to realize any prudential support held in respect of that defaulting market participant.[53] The IESO then has the ability to impose one or more default levies on non-defaulting market participants.[54] This power to impose a default levy provides the IESO with the right to recover from all non-defaulting market participants any amounts owing to the IESO and that have not been paid in full by the defaulting market participant, along with any costs and expenses reasonably incurred by the IESO to investigate the default and to realize any prudential support and to implement the default levy.[55]

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[46] *Market Rules*, Chapter 2, Section 1.2.2.2.

[47] *Ibid.* at Section 5.7.1.

[48] See Section 5.3 re calculation of maximum net exposure and Section 5.8 re allowable reductions.

[49] *Market Rules*, Chapter 3, Section 6.3.1.1.

[50] *Ibid.* at Section 6.3.3.

[51] *Ibid.* at Section 6.3.6.

[52] *Ibid.* at Sections 6.3A.1 and 6.3A.3.

[53] *Market Rules*, Chapter 2, Section 8.2.2.

[54] *Ibid.* at Sections 8.3 and 8.4.

[55] *Ibid.* at Section 8.1.1.

The IESO, therefore, does not assume any debt in the circumstances of a market participant defaulting on a payment. Rather, the IESO will first try to recover the full amount of the default, along with related costs and expenses, by realizing on the prudential support provided by the defaulting market participant. To the extent that there are any further amounts owing to the IESO, the IESO will then issue a default levy in order to recover such further amounts from all non-defaulting market participants. If the IESO is subsequently able to recover further amounts from the defaulting market participant, then such amounts will be allocated back to those non-defaulting market participants on whom the default levy was previously imposed.[56] In short, the Market Rules ensure that the IESO remains revenue neutral, while ensuring its ability to make all payments that it is required to make, including payments to generators such as OPG.

Also worth noting is Section 5.4 of the participation agreement, which establishes the ongoing liability of market participants as follows:

> 5.4 **Ongoing Liability:** Notwithstanding the provisions of section 5.2 or 5.3 above, if the Applicant becomes a terminated market participant or otherwise ceases to be a market participant, as the case may be, the Applicant shall remain subject to and liable for all of its obligations and liabilities as a market participant which were incurred or arose under the market rules prior to the date on which the termination order was issued or the date on which it otherwise ceased to be a market participant, as the case may be, regardless of the date on which any claim relating thereto may be made.

Pursuant to Section 78.1 of the OEB Act, the IESO is required to make such payments to OPG in accordance with orders from the OEB. By statute, the IESO is established as a corporation, the business of which, by legislation, is to be carried out without the purpose of gain or profit. As such, all money it collects must be used for the purpose of fulfilling its obligations in respect of the IESO-administered market and the IESO-controlled grid. These purposes include the making of payments to OPG in accordance with orders of the OEB under Section 78.1. Moreover, by entering into participation agreements, the IESO and market participants such as OPG agree to be contractually bound by the Market Rules. To remain revenue neutral, consistent with its not-for-profit status, under the Market Rules, if any market participant fails to make a payment, including in respect of amounts associated with OPG's deferral and variance accounts, then the IESO has various remedies available to ensure it can collect the funds it needs to make the payments it is required to make to OPG and other generators.

3. Significance of IESO's Licence

You have asked us to consider whether OPG's ability to collect amounts recorded in its deferral and variance accounts, pursuant to an order by the OEB under Section 78.1 of the OEB Act, is dependent upon the renewal of the IESO's licence. It is our conclusion that the IESO's obligation to pay the payment amounts to OPG as a prescribed generator under Subsections 78.1(1) and 78.1(2)(b) is a legal obligation that is independent of the IESO's licensing requirements.

As noted, the IESO currently holds an electricity system operator licence (EI-2008-0096), which took effect on July 31, 2008 and is valid until July 30, 2013. The OEB may extend the term of this licence pursuant to section 5.1 of the licence. For the five-year period prior to the effective date of its current licence, the IESO held a similar licence (EI-2003-0088) from the

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[56] *Ibid.* at Section 8.8.2.

OEB. The requirement to hold such a licence arises from Section 57 of the OEB Act, which states, among other things, that "no . . . person shall, unless licensed to do so under this Part, . . . (g) direct the operation of transmission systems in Ontario; (or) (h) operate the market established by the market rules."[57]

By issuing the licence, the OEB licenses the IESO to:

> direct the operation of the transmission system(s) in accordance with Agreements and the Market Rules, subject to the conditions set out in this Licence (and)
>
> operate the IESO administered markets and to do such things as may be permitted by the Market Rules or required to be done by the Licensee in furtherance of the establishment and operation of the market(s) to be administered by the Licensee, subject to the conditions set out in this Licence.[58]

The licence also requires the IESO to comply with all applicable Market Rules.[59]

It is important to place the IESO's licence in context. In the context of the legislative scheme governing Ontario's electricity system, the IESO's licence is not the only aspect that gives authority to or imposes obligations on the IESO. In fact, the IESO has various statutory obligations which exist independently of the IESO's licence and are not undertaken by the IESO as a condition of the licence.

As noted, Subsection 78.1(1) imposes on the IESO the obligation "to make payments to a generator prescribed by regulations" and Subsection 78.1(2)(b) requires that such payment be in accordance with the order of the OEB. These provisions are significant since, based upon the wording of these provisions: (1) the IESO's obligation to pay the prescribed generator, OPG, is not subject to the IESO's licences; and (2) the IESO's obligation to pay is subject to the OEB order, which must discharge the OEB's obligation to set payment amounts in accordance with the regulations and the just and reasonable standard.[60]

As noted above, the licence and the requirement to obtain a licence is limited in its scope to the direction of the operation of the transmission system and the operation of the market established by the market rules. Pursuant to the market rules, the IESO and market participants are bound to those market rules by way of a contractual arrangement, which is established by the participation agreement that is signed by the IESO and all market participants. The IESO's obligations under section 78.1(1) and section 78.1(2)(b) are not governed by the market rules or the contractual arrangement underlying the market rules. Therefore, one can reasonably conclude that the IESO's obligations under section 78.1(1) and section 78.1(2)(b) exist independent of the licence from the OEB. If the licence ceased to exist, the obligations of the IESO and those of the OEB under Section 78.1 would remain.

Similar to the obligation on the IESO under Section 78.1 of the OEB Act, the legislative scheme also establishes obligations for the IESO to make payments under Sections 78.2 to 78.5 of the OEB Act:

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[57] *Ontario Energy Board Act*, Subsections 57(g) and (h).

[58] *Independent Electricity System Operator Licence* (EI-2008-0096), Section 3.

[59] *Ibid.* at Section 4.

[60] *Supra* Note 1.

- Under 78.2, the IESO is required to make payments to the Ontario Electricity Financial Corporation (OEFC) with respect to electricity supply contracts that the OEFC has with generators.

- Under 78.3, the IESO is required to make payments to the OPA with respect to electricity output generated by units at facilities in respect of which the OPA has entered into procurement contracts.

- Under 78.4, the IESO is required to make payments to the OPA with respect to amounts payable to entities with whom the OPA has entered into procurement contracts for electricity generation capacity.

- Under 78.5, the IESO is required to make payments to distributors or the OPA with respect to amounts approved by the OEB for conservation and demand management programs.

In each of these circumstances, the obligation on the IESO is established by legislation and is independent of any obligations that might otherwise be imposed on the IESO under a licence issued by the OEB.

The IESO also has a number of rights, powers and obligations under Parts II.2 and III of the *Electricity Act* in respect of the electricity markets and the management of supply, capacity and demand. One such obligation, which is of particular significance, is the requirement under Section 25.33 of the *Electricity Act* for the IESO, through its billing and settlement systems, to make adjustments in accordance with regulations to ensure that, over time, payments by classes of market participants in Ontario that are prescribed by regulation reflect amounts paid, in accordance with the regulations, to generators, distributors, the OPA and the OEFC, whether the amounts are determined under the Market Rules or under Sections 78.1 to 78.5 of the OEB Act. The adjustments that the IESO is required to make under this provision, which are further described in O. Reg. 429/04, are known as the "Global Adjustment".

The administration of the Global Adjustment is a critical function established by legislation as it results in the collection and payment of amounts which are based on the difference between the total of all market payments for electricity consumed in the province and the total of all rates and payment amounts to which generators under contract with the OPA and regulated generators are entitled. For OPG, the Global Adjustment ensures that the IESO determines, collects and then pays to OPG the differences between the market price for generation from its prescribed facilities and the regulated rates established by the OEB under Section 78.1 for the prescribed facilities. The IESO's obligation to perform the Global Adjustment is imposed by legislation and is detailed in the regulations thereunder. This obligation is legally independent of any obligations that might otherwise be imposed on the IESO under a licence issued by the OEB.

A decision by the OEB to renew or terminate the IESO licence must be considered within the limits of OEB's jurisdiction. The framework within which the OEB is empowered to make decisions was recently summarized by the Ontario Court of Appeal in *Toronto Hydro-Electric System Ltd. v. Ontario (Energy Board)*, as follows:

> The analysis must begin with the legislation that establishes the OEB and gives the OEB its powers. The OEB's objectives in respect of electricity are stated in s. 1 of the *Ontario Energy Board Act*, 1998, S.O. 1998, c. 15, Sch. B (the "Act"):

Boards objectives, electricity

1.(1) The Board, in carrying out its responsibilities under this or any other Act in relation to electricity, shall be guided by the following objectives:

1. *To protect the interests of customers with respect to prices and the adequacy, reliability and quality of electricity service.*

2. *To promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry.*

In short, the OEB is to balance the interests of ratepayers in terms of prices and service while at the same time ensuring a financially viable electricity industry that is both economically efficient and cost effective.[61] (emphasis added)

With respect to the circumstances where a decision of a tribunal, such as the OEB, will be found to be outside of its jurisdiction and therefore invalid, the court goes on to state:

> Courts should hesitate to analyze the decisions of specialized tribunals through the lens of jurisdiction unless it is clear that the tribunal exceeded its statutory powers by entering into an area of inquiry outside of what the legislature intended. If the decision of a specialized tribunal aims to achieve a valid statutory purpose, and the enabling statute includes a broad grant of open-ended power to achieve that purpose, the matter should be considered within the jurisdiction of the tribunal. ...In contrast, where a tribunal is pursuing an illegitimate objective, or is engaging in actions that clearly defy the limits of its statutory authority, then a reviewing court may properly declare its decisions to be *ultra vires* (i.e. beyond its power or authority).[62] (emphasis added)

Based on the foregoing, it is clear that the OEB is required to make decisions, including licensing decisions, in accordance with its mandate to protect the public interest as set out in Section 1(1) of the OEB Act. Statutory objectives imposed on a tribunal, such as those listed in Section 1(1) of the OEB Act, limit the extent of the tribunal's discretion in making decisions, as delegated by the Legislature, and the tribunal has no power to make a decision outside of the limits of the discretion granted to it.[63] Any attempt to do so will, upon review by a court, be deemed *ultra vires* and declared invalid.[64] The OEB's public interest mandate includes the need to protect the interests of ratepayers, as well as to ensure the maintenance of a financially viable electricity industry. To the extent that the OEB makes a decision that is inconsistent with these statutorily mandated objectives, a reviewing court would, therefore, be likely to declare such decision to be invalid on the basis that the OEB acted outside of its jurisdiction in making the decision. The OEB cannot arbitrarily decide to cancel the IESO's licence or to not renew the IESO's licence. Rather, the OEB must make licensing decisions in accordance with its public interest mandate.[65]

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[61] *Toronto Hydro-Electric System Ltd. v. Ontario (Energy Board)*, 99 O.R. (3d) 481, Ont. C.A., Apr. 20, 2010 (leave to appeal to SCC denied, Dec. 2, 2010) at paras 12 to 14.

[62] *Ibid.* at para 24 (parenthesis and emphasis added).

[63] See D. Jones and A. de Villars, *Principles of Administrative Law* (5th ed.), Carswell, 2009 at p. 93-94.

[64] *Ibid.* at 94.

[65] *Toronto Hydro-Electric System Ltd. v. Ontario (Energy Board), Supra* note 62.

In exercising its licensing powers, the OEB's discretion is constrained by the need to fulfill its statutory public interest mandate in conjunction with its obligation to set just and reasonable rates and payment amounts. Under Section 78.1, the OEB is obligated to make payment amount orders in accordance with the regulation and in accordance with the just and reasonable standard[66] in connection with OPG's prescribed facilities. The obligations are not conditional upon the OEB issuing or renewing the IESO's licence. Although the obligation under Subsections 78.1(1) and 78.1(2)(b) is legally independent from the IESO's licence, if the licence is terminated or not renewed, then the obligation under Subsections 78.1(1) and 78.1(2)(b) would continue. However, from a practical perspective, without a valid licence the IESO would not be in a position to carry out the settlement function for the market under the market rules by flowing funds between customers or end-users and generators. Since the underlying obligations in Section 78.1 (and other statutory provisions set out above) are not eliminated as a consequence of licence termination, this appears to be an impractical result.

The OEB has an obligation to act and make decisions in accordance with its public interest mandate, which includes an obligation to establish just and reasonable payment amounts for OPG under Section 78.1. As discussed earlier in this letter, the Supreme Court of Canada has described just and reasonable rates as "rates, which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested."[67] Fair compensation to a utility is comprised of the right to recover all prudently incurred costs, and the right to a fair return on invested capital. As noted, allowing a utility to earn a fair return has been regarded by the courts as being essential to the preservation of the financial integrity of a utility, which is of mutual concern to the utility and its customers.[68] Accordingly, in the context of its public interest mandate, which includes the objective of facilitating the maintenance of a financially viable electricity industry and establishing just and reasonable rates and payment amounts, it is necessary for there to be an effective mechanism in place that enables OPG to actually receive its payment amounts pursuant to orders of the OEB under Section 78.1.

It would be incumbent on the OEB to consider these significant implications in the course of exercising its licensing authority in accordance with the public interest and its purposes and objects under Section 1 of the OEB Act. A decision to the contrary would be beyond its jurisdiction and could be rendered null and void by a reviewing court.[69]

Accordingly, the OEB would only be able to cancel or refuse to renew the IESO's licence (a) if it could find that doing so would be in the public interest, and (b) if it is able to meet its statutory obligations, including its obligations in respect of setting just and reasonable payment amounts that provide for a fair return to OPG. In exercising its licensing powers, the OEB would also have to consider that, as discussed, the IESO's obligations under Section 78.1 exist independent of and are outside the scope of the licence from the OEB.

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[66] *Supra* Note 1.

[67] *Supra* note 5.

[68] *Supra* note 10.

[69] *Supra* note 63 at 188-189.

D. Reliance

This opinion is given exclusively in connection with the consideration by OPG, as well as OPG's accounting advisors and auditors, of the appropriate treatment of OPG's regulatory deferral and variance accounts for financial reporting purposes under IFRS and for no other purpose. This opinion is addressed to and is solely for the benefit of OPG and may not be relied upon by any other person including, but not limited to, OPG's accounting advisors and auditors.

We trust the forgoing is satisfactory.

Yours truly,

Torys LLP