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OPINION

TO: Carolyn Calwell, Director,
Legal Services Branch,
Ministry of Energy

FROM: Padraic Ryan, Counsel,
Constitutional Law Branch

DATE: February 10, 2017

RE: **Proposal to Defer Global Adjustment Charges**

The Ministry of Energy (“Ministry”) has requested legal advice on the constitutional risk posed by a proposal to defer the current cost to consumers of the global adjustment (GA), to be paid for by consumers in future years.

This advice is provided on an urgent basis and is further to the opinion given by Sean Hanley on January 31, 2017, which is provided as an appendix.

This opinion re-states the general legal principles and then applies them to the proposal the Ministry provided on February 9, 2017.

OVERVIEW

In order to remain compliant with the principles of constitutional law governing taxes and regulatory charges, electricity consumers should be paying roughly their proportionate share of electricity costs, subject to deviations supported by regulatory goals closely tied to how the consumers benefit or cause the need for the regulation.

Electricity consumers are charged for the GA, which recoups the costs incurred from contracts entered with suppliers to ensure sufficient generation capacity to meet provincial needs. Provided these contracts are normal commercial transactions, there is no tax versus regulatory fee issue in passing these costs on to consumers. The contracts, regardless of their duration, merely reflect the commercial marketplace.

It is also open to the province to recover the market cost of ensuring generating capacity up front with richer contract prices to incent investment in generation capacity in the early period and, instead of passing those costs immediately to the current generation of consumers, the cost could spread over the lifespan of the asset, on the ground that future consumers cause the need for and benefit from that generation asset just as current ratepayers do.

While courts will not insist on exactitude in allocating costs to those consumers who cause the need for and benefit from these assets, where a sufficient connection between those paying these charges and the reason for them is lacking, there is a greater risk that the court will conclude the charge is a tax exacted to generate revenue, rather than further regulatory goals.

Legal risk therefore arises if it becomes apparent that the Government is not spreading cost so that it is shared proportionately by future consumers who cause a need for and benefit from the generation asset, but rather is doing so in order to lower the price in the short term by increasing the price in the long term. If the proposed financing served to encumber future consumers with a premium payment to cover the GA financing in order to subsidize current ratepayers, then there would be a **moderately high constitutional risk**¹ that the financing proposal would result in an unconstitutional tax.

Based on our understanding of the February 9, 2017 proposal, it creates a refinancing structure which results in future consumers paying disproportionately more of the GA cost and therefore cross-subsidizing near-term consumers. This means that it is at a **moderately high constitutional risk** of resulting in an unconstitutional tax.

If, however, future consumers who cause the need for and benefit from this future capacity would share proportionately in the cost of financing the required assets, the proposal would pose only a **low constitutional risk**.²

The lowest risk approach to financing the GA would be to spread the costs of the assets financed by the GA over their useful life expectancy, so that ratepayers today and in the future share proportionately in the costs of the assets from which they benefit and cause the need for. Normal accounting rules can be used for dealing with financing costs and the change in the future value of money. The accounting based on the value and useful life expectancy of the assets comprising the GA would determine how much can be reasonably removed from the current GA and the period in which it should be recovered.

BACKGROUND

The request for legal advice arises in the context of increasing electricity costs resulting in part from substantial investment needed to lower greenhouse gas (GHG) emissions to decarbonize and modernize the province's electricity infrastructure.

¹ Moderately high risk means that although it is difficult to predict the outcome because there are good arguments on both sides, a court correctly applying the relevant law would be more likely to find the proposal invalid.

² Low risk means that while there are credible arguments against the proposal, a court correctly applying the relevant law would very likely dismiss a constitutional challenge.

Global Adjustment Assets' Useful Life Expectancy vs. Current Contract Terms

The proposal would involve cost deferral of the GA. The GA was established by the Government in 2005 and appears either as a separate line on certain consumers' electricity bills (i.e., Class A or Class B consumers not on the Regulated Price Plan, and consumers who are customers of energy retailers) or is factored into the commodity cost of electricity for consumers who are covered by the Ontario Energy Board's Regulated Price Plan, and is, in general terms, designed to cover the cost of providing adequate generating capacity and conservation / demand or "load" management programs. The Ministry advises that the GA costs arise because the marketplace is unlikely to supply new generation capacity because the significant cost and low rates of return make it commercially unviable. As a result, contracts are negotiated with suppliers to incent the marketplace to build the generating assets.

In broad terms, the GA is calculated based on:

- The difference between the Hourly Ontario Energy Price (HOEP) and Ontario Power Generation's regulated nuclear and hydro base load generation;
- The difference between the Hourly Ontario Energy Price (HOEP) and the Independent Electricity System Operator's (IESO)³ and legacy Ontario Power Authority's contracts with generators;
- The difference between the Hourly Ontario Energy Price (HOEP) and contracted rates administered by the Ontario Electricity Financial Corporation paid to existing non-utility generators (NUGs), and
- The cost of conservation and demand-management programs.

The GA is calculated based on a formula that responds to changes in the HOEP, and total monthly GA varies from month to month based on the difference between the HOEP and the regulated or contracted rates. Generally, when the HOEP is lower, the GA is higher to cover additional costs for the items referenced above. This is primarily a function of the generation and capacity contracts, the costs of which are recovered through the GA. The GA is also impacted when new projects come into service, contract payments take effect or as a result of changes in Ontario electricity demand. Finally, the GA is charged to "Class A" consumers on a different basis than "Class B" consumers. "Class A" consumers (which must have a maximum hourly demand for electricity in a month in excess of an average of three megawatts (MW) (and commencing July 1, 2017, one MW) are charged GA based on their contribution to total system peak demand measured by the IESO, as system operator, during the five highest-peak hours in each year. All other consumers are "Class B" consumers, and pay GA based on the volume of electricity they use each month. Consumers are billed GA on a monthly basis by their distributors (if they are distribution-connected) or by the IESO (if they are larger, transmission-connected consumers).

³ The IESO is a not-for-profit, non-Crown agent corporate entity established in 1998 as the Independent Market Operator (IMO) by the *Electricity Act, 2008* and continued as the IESO. The IESO is governed by an independent Board whose Chair and Directors are appointed by the Government of Ontario. After its 2015 merger with the legacy Ontario Power Authority, the IESO's current functions are to ensure there is enough power to meet the province's energy needs in real time while also planning and securing energy for the future.

The Ministry advises that some of the contracted electricity generation assets that form part of the GA include gas plants that are expected to have a useful life that extends beyond the term of their current financial contracts, which typically run about 20 years. Amounts paid through the GA in respect of these generation assets include costs associated with capital investment and financing to build supply and capacity, plus a reasonable return. These include amounts paid pursuant to contracts between the IESO (and legacy Ontario Power Authority) with Ontario Power Generation (OPG) in relation to biomass and hydro-electric facilities and with the Ontario Electricity Financial Corporation (OEFC) in relation to non-utility generators. The generation assets would be fully paid under these contracts but are anticipated to continue to function beyond their contract term, subject to regulatory changes, maintenance and refurbishment needs. Therefore the cost of these assets are currently being financed through the GA based on the 20 year contract terms, while the assets are expected to continue to provide a residual benefit to consumers well beyond the contracts' terms. This residual benefit would likely accrue to consumers in the negotiation of the purchase of future electricity generation, because the owner of the generating asset no longer has to recover the costs of acquiring the asset (e.g. a natural gas generator).

The Ministry also advises that renewable energy generation assets, like wind and solar, also have a useful life expectancy that is expected to extend beyond the term of their current contract terms. Hence, future consumers are expected to receive a residual benefit from assets such as wind farms and solar generation after the capital costs are paid off over the 20 year life of the contract. Once again, this may inure to the benefit of future consumers as contracts are negotiated for the supply of electricity from assets whose capital costs have already been recouped. Amounts paid through the GA in respect of renewable energy assets include payments to third party market participants under contracts in respect of renewable energy generation, including the Renewable Standard Offer Program (RESOP), Renewables ("RES") I, II or III, the Feed-in Tariff (FiT) and Micro-FiT Programs. The Ministry advises that in addition to economic benefits, this investment in renewable energy sources also provides non-pecuniary benefits to both current and future consumers in shifting the Province's energy market away from carbon-based generation.

Similarly, the costs of investment in conservation, which are recovered through the GA based on current contract terms, are expected to provide benefits to consumers who use the electricity system over the course of many years beyond the contract terms. Amounts paid in respect of conservation include payments for reducing demand during peak system periods, more energy efficient equipment replacement, and shutting down or reducing reliance on energy-consuming equipment during peak hours (demand response/shedding load). Present investment in conservation creates assets in the form of more energy efficient facilities that are of benefit to future consumers, and resulting in reduced strain on the system that defers or obviates the need to make future investments in generation replacement, transmission and distribution reinforcement or upgrades. The IESO reports that conservation programs made up approximately 4% of the total GA cost in 2016.

The Ministry advises that the IESO, which is considered an expert authority, provides support for the expectation that some of the above assets will have a useful life beyond the term of their financial contracts. According to the IESO, contracts for natural gas-fired and renewable supply

assets totaling 17 Gigawatts (GW) of installed capacity in 2015 will reach the end of their terms by 2035 or before. Most of the contracts for natural gas-fired and renewable supply assets have been committed for terms of 20 years but, with some reinvestment, have a design life extending well beyond the term of their contracts.⁴

The Ministry also advises that the generation assets included in the GA also consist of the amounts related to the base load nuclear assets – that is, Pickering, Darlington and Bruce nuclear generators. It is anticipated that the Pickering generator will cease to operate by 2024. The cost of the other two generators is already built into the financial arrangements applicable to Darlington and Bruce, to defer the infrastructure cost to be borne by ratepayers who consume the power that they generate, both present and future. The Ministry advises that the nuclear generation assets costs are already recovered on the basis of the expected useful life of the facilities.

ANALYSIS

A. Legal Principles

The principles of constitutional law governing taxes and regulatory charges are reviewed in detail in our previous opinions relating to the GA charge, dated May 17, 2004, November 28, 2008, July 21, 2010 and September 10, 2012. In particular, we refer the reader to a synthesis of the applicable principles of law provided in the memorandum dated November 28, 2008 (at 6-7).

In short, the central task is to determine whether the primary purpose of a levy is, in “pith and substance”, to tax, *i.e.*, to raise revenue for general purposes, or rather, to finance or constitute a regulatory scheme or charge for services directly rendered.⁵ Unlike a tax, a regulatory charge intended to defray costs must be “ancillary or adhesive to a valid regulatory scheme”.⁶

The Supreme Court of Canada has identified four major *indicia* to be considered in assessing whether a levy is connected to a regulatory scheme: (1) a complete, complex and detailed code of regulation, (2) a specific regulatory purpose which seeks to affect the behaviour of individuals, (3) the existence of actual or properly estimated costs of regulation, and (4) a relationship between the regulation and the person being regulated, where the person being regulated either causes the need for the regulation or benefits from it.⁷ A consideration of the extent to which those *indicia* are satisfied constitutes the “first step” of the analysis.⁸ The Court has explained that a required “second step” of the analysis is that “in order for a regulatory charge intended to defray the costs of a regulatory scheme to be ‘connected’, the fee revenue must be tied to the costs of the regulatory scheme”.⁹ Courts will not insist that fees correspond precisely to the cost of the relevant service provided there is a reasonable connection between the

⁴Ontario Planning Outlook: A technical report on the electricity system, IESO (September 1, 2016).

⁵ *Westbank First Nation v. British Columbia Hydro and Power Authority*, [1999] 3 S.C.R. 134 at para. 30.

⁶ *Allard Contractors Ltd. v. Coquitlam (District)*, [1993] 4 S.C.R. 371 at para. 58.

⁷ *Westbank*, *supra* at paras. 24, 27 and 44; *620 Connaught Ltd. v. Canada (Attorney General)*, [2008] 1 S.C.R. 131 at para. 25.

⁸ Not all *indicia* need be present to find a regulatory scheme: *Westbank* at para. 24. Nonetheless, there must be criteria establishing a regulatory scheme and its relevance to the person being regulated: *Connaught* at para. 26.

⁹ *Connaught* at para. 38.

cost of the service provided and the amount charged.¹⁰ Where a sufficient connection between the person paying, the reason for the charge and the amount of the charge is lacking, however, there is a greater risk that the court will conclude the levy is an tax exacted to generate revenue, rather than further regulatory goals.¹¹ If the proposed charge were a tax, then to be constitutionally valid it would have to be clearly and unambiguously imposed by a statute originating in the legislature.¹²

Our previous opinions related to the GA charge concluded that the legislative framework under the *Electricity Act, 1998*, *Ontario Energy Board Act, 1998*, and the extensive set of regulations made thereunder, constituted a regulatory scheme with regulatory purpose that seeks to affect the behavior of individuals and is a complete code of regulation, satisfying the first two indicia (CLB opinion dated May 17, 2004 (at 19) and November 28, 2008 (at 8-9)). The third indicium is also satisfied as there are actual costs of regulation pertaining to providing for adequate generating capacity and conservation, which are financed through the GA.

We focus below on the fourth indicium of a regulatory charge, being whether the GA financing proposal would support a sufficient relationship between the regulation and the person regulated, such that the individual subject to the regulatory charge either causes the need for the regulation or derives a benefit from it.

A key indicium of a regulatory scheme is a relationship between the regulation and the person regulated, in which the individual subject to the regulatory charge either causes the need for the regulation or derives a benefit from it. In *Westbank* (at para. 28), Gonthier J. described this indicium as follows:

Finally, the individual subject to the regulatory charge will usually either benefit from the regulation, or cause the need for the regulation: Magnet, *supra*, at p. 459. In *Allard*, *supra*, the gravel trucks caused the need for the repair to the roads; in *Ontario Home Builders'*, *supra*, the developers and the new home-owners caused the need for the new schools. In both cases the individuals being charged also benefited from the regulation.¹³

Based on the information that the Ministry has provided, consumers of electricity in the future, cause the need to ensure long-term planning of electricity generation and conservation. As we noted in our previous opinion dated May 17, 2004 (at 22), providing for the reliability of electricity supply, in both the short and long term, is a critical function of the regulatory scheme governing electricity and electricity markets.

Future consumers could also derive a benefit from the continued utility of the assets, the cost of which is passed on to consumers in GA charges. The information provided by the Ministry is that these assets include gas plants and renewable generation assets, and conservation assets, which are anticipated to be paid for prior to the exhaustion of their useful lifespan. Assuming the

¹⁰ *Eurig Estate (Re)*, [1998] 2 SCR 565 at para 22.

¹¹ *Connaught* at para 20.

¹² *Eurig* at para. 41.

¹³ *Westbank*, *supra* at para. 28.

supplier remains in business, the generation assets would continue to generate electricity and thereby provide an economic benefit to future consumers after they have been paid for, subject to any applicable regulatory change, maintenance and refurbishment needs. The conservation assets that would be paid for by current consumers could also benefit future consumers both through their continued conservation utility to those future consumers and through the deferral or obviation, due to reduced demand, of further investment that would otherwise be necessary to renew or refurbish existing generation and transmission assets.

Even though these generation and conservation assets may not be owned by the Province, their continued useful lifespan beyond the term over which the asset is paid for is a potential benefit to those consumers who would then be able to purchase electricity generated by these assets, without the need to fund the financing of the creation of new generation assets.

While future consumers may benefit from the continued utility of the asset after it has been paid for by current consumers, these costs to current consumers result from normal commercial transactions that merely reflect the commercial marketplace, and do not raise any tax versus regulatory fee issues.

It would also be open to the Government to satisfy the market cost of ensuring generating capacity up front with richer contract prices to incentivize investment in generation capacity in the early period and, instead of passing those costs immediately to the current generation of consumers, to spread the cost over the lifespan of the asset, on the ground that future consumers cause the need for and benefit from that generation asset just as current ratepayers do. However, where a sufficient connection between those paying these charges and the reason for them is lacking, there is a greater risk that the court will conclude the charge is a tax exacted to generate revenue, rather than further regulatory goals.

Legal risk therefore arises, however, if it becomes apparent that the Government is not spreading cost so that it is shared by future consumers who cause a need for and benefit from the assets, but rather is doing so in order to lower the price for current consumers by increasing the price for future consumers. If the proposed financing served to encumber future consumers with a premium payment to cover the GA financing in order to subsidize current ratepayers, unrelated to future benefits, then there would be a **moderately high constitutional risk** that the financing proposal would result in an unconstitutional tax absent some other regulatory or economic rationale sufficiently connected to the regulatory scheme to maintain the necessary nexus between those who pay and those who cause the need for or benefit from the regulated scheme.

So long as the particular underlying assets have useful life expectancies beyond the terms of their existing contracts, such that future consumers who cause the need for and benefit from this future capacity would share in the cost of financing the required assets, the proposal would pose only a **low constitutional risk**.

B. Application of Legal Principles to the Current Proposal

The Ministry has provided the attached deck entitled Rate Mitigation Plan Options (dated February 9th, 2017 and attached hereto) at slides 3, 4 and 24 through 32 which describe two

options for refinancing the Global Adjustment through borrowing (“Options 1/2”). This proposal contains no reference to a relationship between the structure of the refinancing and the estimated useful life of the assets which are being amortized. As described above, this is the main determinant of the risk level associated with the proposed GA refinancing scheme, because that structure determines whether future consumers are repaying more debt generated by near-term consumers (that is, those consumers whose electricity bills would be lowered within the first several years of the 30-year refinancing option) than is proportionate to the benefit future consumers receive from the useful life of the assets. Options 1/ 2 appear to be designed based on what structure can achieve the desired magnitude of the reduction to be obtained over the short-term on consumers’ electricity bills, within the context of a 30-year repayment structure.

By way of comparator, the Ministry has also provided separate slides dealing with two specific GA refinancing scenarios (also attached) which show Ministry calculations estimating how residential bills would be affected by a refinancing plan based on amortizing all 20-year generation contracts for an additional 10 years, as well as amortizing conservation costs over 15 years (“20+10 Scenario”). The Ministry has have advised that these 20+10 Scenario estimates are in themselves liberal (as to the benefit received from the assets by future consumers), because not every asset has a useful life that exceeds their 20 year contract terms. Subject to that caveat, the 20+10 Scenario attracts less risk because the repayment of debt by future consumers tracks more closely the proportion of the benefit they receive from the assets.

The difference between Options 1/2 and the 20+10 Scenario appears to be the magnitude of cost which is redistributed from future consumers to near-term consumers. In particular, the bill impact on 2017 and 2018 consumers is a reduction in Options 1/2 that is roughly triple the size of the reduction envisioned in the 20+10 Scenario (see Options 1/2 deck p. 29 and 20+10 Scenario deck p. 1). This results in a similarly higher repayment cost for 2030-2047 consumers.

By comparing the two scenarios, it appears that Options 1/2 result in more repayment from future consumers than is proportionate to the benefit they received based on their share of the useful life of the assets.

By way of example, the chart we have provided below shows how a (completely hypothetical) refinancing model over a fixed time period could be modified to provide more or less proportionality in imposing costs on future consumers:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
True GA cost	100	100	100	80	60	40
Average per year GA cost	80					
*Both models assume 6 year useful life of assets + no financing costs						
Model A - Perfectly proportionate refinancing						
Paid to GA by ratepayers	80	80	80	80	60	40
Paid to GA from debt	20	20	20	0	0	0
Paid from ratepayers to debt	0	0	0	0	20	40
Ratepayer pays	80	80	80	80	80	80
Model B - Disproportionately back-loaded refinancing						
Paid to GA by ratepayers	60	70	80	80	60	40
Paid to GA from debt	40	30	20	0	0	0
Paid from ratepayers to debt	0	0	0	10	30	50
Ratepayer pays	60	70	80	90	90	90

In Model B above, Years 1-3 pay less than Years 4-6 despite having the benefit of the asset for the same amount of time. To the extent that we have correctly understood that Options 1/2 share this same feature, the result is a cross-subsidy from future consumers to near-term consumers. That is the core basis of the scenarios identified above as being at a **moderately high risk** of resulting in an unconstitutional tax due to future consumers having to pay more than is proportionate to the benefit they receive from the scheme.

Part of the difficulty may be that the IESO forecast in pages 28 and 30 of the Options 1/2 deck is for total residential bill (commodity price plus GA cost) and does not isolate the true GA cost as compared to the refinanced GA cost. Risk is reduced to the extent that the refinancing gives the GA cost the smoothest possible distribution (curve) over the best estimate of the useful life of the portfolio of assets being amortized or refinanced. Model A above gives an example of a perfectly flat GA cost that would pose only a low risk. We note that the shape of the curve of the total residential bill is not helpful to analyzing this since it is affected by projections of the commodity price.

We consider there to be no additional risk posed by the limiting of GA refinancing to Regulated Price Plan (“RPP”) consumers, so long as non-RPP consumers do not cross-subsidize RPP consumers by having to make payments towards the debt incurred for the refinancing.

Finally, we note that the provided version of the Options 1/2 deck indicates a proposed annual cap of \$3.2 billion. As set out in the January 31, 2017, opinion, while courts have typically accepted some year-to-year variation in the relationship between the revenue from regulatory charges and the actual cost of the scheme, if the annual cap resulted in sustained deferrals of costs to future consumers (that were disproportionate to the benefits received by future

consumers from the generators), then this would increase the risk of the option resulting in unconstitutional tax.

We trust that the foregoing is of assistance, and would be pleased to discuss at your convenience.

PJR

APPENDIX**Ministry of the
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TO: Carolyn Calwell, Director,
Legal Services Branch,
Ministry of Energy

FROM: Sean Hanley, Counsel,
Constitutional Law Branch

DATE: January 31, 2016

RE: **Proposal to Defer Global Adjustment Charges**

The Ministry of Energy (“Ministry”) has requested legal advice on the constitutional risk posed by a proposal to defer the current cost to consumers of the global adjustment (GA), to be paid for by consumers in future years.

The request for advice is urgent, arising at a preliminary stage of policy development with a fast-tracked target of introducing legislation the week of February 20, 2017 (tentative). Some information relevant to the legal analysis respecting the particular assets involved in the financing proposal is not available at this time, and we have been asked to provide advice based on more general descriptions of asset categories, the remaining terms on their existing financing contracts, and estimates of their useful life expectancy.

We understand that additional information will become available as the proposal unfolds and policy options are developed. We would be pleased to provide further advice as relevant information becomes available.

SUMMARY ADVICE

In order to remain compliant with the principles of constitutional law governing taxes and regulatory charges, electricity consumers should be paying roughly their proportionate share of electricity costs, subject to deviations supported by regulatory goals closely tied to how the consumers benefit or cause the need for the regulation.

Electricity consumers are charged for the GA, which recoups the costs incurred from contracts entered with suppliers to ensure sufficient generation capacity to meet provincial needs. Provided these contracts are normal commercial transactions, there is no tax versus regulatory fee issue in passing these costs on to consumers. The contracts, regardless of their duration, merely reflect the commercial marketplace.

It is also open to the province to recover the market cost of ensuring generating capacity up front with richer contract prices to incent investment in generation capacity in the early period and, instead of passing those costs immediately to the current generation of consumers, the cost could spread over the lifespan of the asset, on the ground that future consumers cause the need for and benefit from that generation asset just as current ratepayers do.

While courts will not insist on exactitude in allocating costs to those consumers who cause the need for and benefit from these assets, where a sufficient connection between those paying these charges and the reason for them is lacking, there is a greater risk that the court will conclude the charge is a tax exacted to generate revenue, rather than further regulatory goals.

Legal risk therefore arises if it becomes apparent that the Government is not spreading cost so that it is shared proportionately by future consumers who cause a need for and benefit from the generation asset, but rather is doing so in order to lower the price in the short term by increasing the price in the long term. If the proposed financing served to encumber future consumers with a premium payment to cover the GA financing in order to subsidize current ratepayers, then there would be a **moderately high constitutional risk**¹⁴ that the financing proposal would result in an unconstitutional tax.

Provided, however, that the particular underlying assets have useful life expectancies beyond the terms of their existing contracts, such that future consumers who cause the need for and benefit from this future capacity would share proportionately in the cost of financing the required assets, the proposal would pose only a **low constitutional risk**.¹⁵

The lowest risk approach to financing the GA would be to spread the costs of the assets financed by the GA over their useful life expectancy, so that ratepayers today and in the future share proportionately in the costs of the assets from which they benefit and cause the need for. Normal accounting rules can be used for dealing with financing costs and the change in the future value of money. The accounting based on the value and useful life expectancy of the assets comprising the GA would determine how much can be reasonably removed from the current GA and the period in which it should be recovered. Therefore, in order to minimize risk, it is recommended that you select an option that approximates this model as closely as possible.

The risk posed by the proposal would increase the further the proposal moves from a proportionate sharing of cost among consumers who cause a need for and benefit from the assets, toward deferring cost recovery to future consumers who do not cause a need for or benefit from

¹⁴ Moderately high risk means that although it is difficult to predict the outcome because there are good arguments on both sides, a court correctly applying the relevant law would be more likely to find the proposal invalid.

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the assets, in order to subsidize current consumers. Based on our understanding of the information provided by the Ministry at this time, potential scenarios that could increase risk to the moderately high range would include an unduly longer or shorter financing period so that earlier or later consumers are made to subsidize the other class without a sound regulatory or economic rationale. For instance if the proposed financing model were to defer the recovery of the cost of a generator to a future generation of consumers who could not benefit from the generator because it is unlikely to still be in operation at that time (i.e. after the end of its normal life), risk would arise from the cross subsidization of current consumers by later consumers. Similarly, the proposals to cap amounts added to future GA payments to repay the loans could also increase risk if they result in significant cross-subsidization. While small adjustments intended to smooth out sharp increases or decreases to the payments are likely defensible, a blanket cap that results in future consumers paying for assets that have ceased providing any benefit would be inconsistent with proportionate sharing.

Our assessment of low risk depends substantially on our understanding that the proposed financing would defer costs in relation to assets that are to be paid for under existing contracts, where the asset is expected to have a longer useful life expectancy than the term of the contract, such that the costs of these assets would be spread to include future consumers who would benefit from the assets' residual utility. Assumptions that could impact the risk assessment if changed include the particular amount to be borrowed, the time frame for repayment, the particular assets, their value, remaining contract term, and expected useful lifespan.

Finally, it may be possible to successfully defend a refinancing scheme on some basis other than the value of the generating asset. For instance, there may be a regulatory or economic rationale sufficiently connected to the regulatory scheme to maintain the necessary nexus between those who pay and those of cause the need for or benefit from the regulated scheme. For instance, we are not in a position to advise that the status quo raises particular risk merely because the GA currently recovers the current costs of contracts in respect of generating assets that have life expectancies well beyond the current contracts. There may well be a legitimate commercial justification that suppliers would not build new electrical generation capacity without some significant front loading of its costs. There is nothing in the *Eurig* jurisprudence that requires the government to override commercial realities in the setting of reasonable cost recover charges. However, where the government seeks to change commercial arrangements in order to benefit current ratepayers at the expense of future ratepayers under circumstances where the latter neither cause nor benefit from the change, a moderately high risk would ensue absent some other regulatory or economic rationale bearing a sufficient nexus.

We would be pleased to provide further advice as the policy options in this respect are developed.

BACKGROUND

The request for legal advice arises in the context of increasing electricity costs resulting in part from substantial investment needed to lower greenhouse gas (GHG) emissions to decarbonize and modernize the province's electricity infrastructure.

Global Adjustment Assets' Useful Life Expectancy vs. Current Contract Terms

The proposal would involve cost deferral of the GA. The GA was established by the Government in 2005 and appears either as a separate line on certain consumers' electricity bills (i.e., Class A or Class B consumers not on the Regulated Price Plan, and consumers who are customers of energy retailers) or is factored into the commodity cost of electricity for consumers who are covered by the Ontario Energy Board's Regulated Price Plan, and is, in general terms, designed to cover the cost of providing adequate generating capacity and conservation / demand or "load" management programs. The Ministry advises that the GA costs arise because the marketplace is unlikely to supply new generation capacity because the significant cost and low rates of return make it commercially unviable. As a result, contracts are negotiated with suppliers to incent the marketplace to build the generating assets.

In broad terms, the GA is calculated based on:

- The difference between the Hourly Ontario Energy Price (HOEP) and Ontario Power Generation's regulated nuclear and hydro base load generation;
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- The difference between the Hourly Ontario Energy Price (HOEP) and contracted rates administered by the Ontario Electricity Financial Corporation paid to existing non-utility generators (NUGs), and
- The cost of conservation and demand-management programs.

The GA is calculated based on a formula that responds to changes in the HOEP, and total monthly GA varies from month to month based on the difference between the HOEP and the regulated or contracted rates. Generally, when the HOEP is lower, the GA is higher to cover additional costs for the items referenced above. This is primarily a function of the generation and capacity contracts, the costs of which are recovered through the GA. The GA is also impacted when new projects come into service, contract payments take effect or as a result of changes in Ontario electricity demand. Finally, the GA is charged to "Class A" consumers on a different basis than "Class B" consumers. "Class A" consumers (which must have a maximum hourly demand for electricity in a month in excess of an average of three megawatts (MW) (and commencing July 1, 2017, one MW) are charged GA based on their contribution to total system

¹⁶ The IESO is a not-for-profit, non-Crown agent corporate entity established in 1998 as the Independent Market Operator (IMO) by the *Electricity Act, 2008* and continued as the IESO. The IESO is governed by an independent Board whose Chair and Directors are appointed by the Government of Ontario. After its 2015 merger with the legacy Ontario Power Authority, the IESO's current functions are to ensure there is enough power to meet the province's energy needs in real time while also planning and securing energy for the future.

peak demand measured by the IESO, as system operator, during the five highest-peak hours in each year. All other consumers are “Class B” consumers, and pay GA based on the volume of electricity they use each month. Consumers are billed GA on a monthly basis by their distributors (if they are distribution-connected) or by the IESO (if they are larger, transmission-connected consumers).

The Ministry advises that some of the contracted electricity generation assets that form part of the GA include gas plants that are expected to have a useful life that extends beyond the term of their current financial contracts, which typically run about 20 years. Amounts paid through the GA in respect of these generation assets include costs associated with capital investment and financing to build supply and capacity, plus a reasonable return. These include amounts paid pursuant to contracts between the IESO (and legacy Ontario Power Authority) with Ontario Power Generation (OPG) in relation to biomass and hydro-electric facilities and with the Ontario Electricity Financial Corporation (OEFC) in relation to non-utility generators. The generation assets would be fully paid under these contracts but are anticipated to continue to function beyond their contract term, subject to regulatory changes, maintenance and refurbishment needs. Therefore the cost of these assets are currently being financed through the GA based on the 20 year contract terms, while the assets are expected to continue to provide a residual benefit to consumers well beyond the contracts’ terms. This residual benefit would likely accrue to consumers in the negotiation of the purchase of future electricity generation, because the owner of the generating asset no longer has to recover the costs of acquiring the asset (e.g. a natural gas generator).

The Ministry also advises that renewable energy generation assets, like wind and solar, also have a useful life expectancy that is expected to extend beyond the term of their current contract terms. Hence, future consumers are expected to receive a residual benefit from assets such as wind farms and solar generation after the capital costs are paid off over the 20 year life of the contract. Once again, this may inure to the benefit of future consumers as contracts are negotiated for the supply of electricity from assets whose capital costs have already been recouped. Amounts paid through the GA in respect of renewable energy assets include payments to third party market participants under contracts in respect of renewable energy generation, including the Renewable Standard Offer Program (RESOP), Renewables (“RES”) I, II or III, the Feed-in Tariff (FiT) and Micro-FiT Programs. The Ministry advises that in addition to economic benefits, this investment in renewable energy sources also provides non-pecuniary benefits to both current and future consumers in shifting the Province’s energy market away from carbon-based generation.

Similarly, the costs of investment in conservation, which are recovered through the GA based on current contract terms, are expected to provide benefits to consumers who use the electricity system over the course of many years beyond the contract terms. Amounts paid in respect of conservation include payments for reducing demand during peak system periods, more energy efficient equipment replacement, and shutting down or reducing reliance on energy-consuming equipment during peak hours (demand response/shedding load). Present investment in conservation creates assets in the form of more energy efficient facilities that are of benefit to future consumers, and resulting in reduced the strain on the system that defers or obviates the need to make future investments in generation replacement, transmission and distribution

reinforcement or upgrades. The IESO reports that conservation programs made up approximately 4% of the total GA cost in 2016.

The Ministry advises that the IESO, which is considered an expert authority, provides support for the expectation that some of the above assets will have a useful life beyond the term of their financial contracts. According to the IESO, contracts for natural gas-fired and renewable supply assets totaling 17 Gigawatts (GW) of installed capacity in 2015 will reach the end of their terms by 2035 or before. Most of the contracts for natural gas-fired and renewable supply assets have been committed for terms of 20 years but, with some reinvestment, have a design life extending well beyond the term of their contracts.¹⁷

The Ministry also advises that the generation assets included in the GA also consist of the amounts related to the base load nuclear assets – that is, Pickering, Darlington and Bruce nuclear generators. It is anticipated that the Pickering generator will cease to operate by 2024. The cost of the other two generators is already built into the financial arrangements applicable to Darlington and Bruce, to defer the infrastructure cost to be borne by ratepayers who consume the power that they generate, both present and future. The Ministry advises that the nuclear generation assets costs are already recovered on the basis of the expected useful life of the facilities.

The Ministry advises that options for monetizing all of these contracted assets or deferring the costs associated with these contracts are being explored.

Proposal to Finance Global Adjustment Assets

Since the GA includes costs related to the contractual life of generation assets, there may be an opportunity to recognize the longer-term benefit of the assets to the electricity system, by deferring some of the current costs being charged to consumers today. This would result in these costs being borne by consumers in the future who will continue to benefit from those assets whose useful life continues beyond the term of their current contract. The GA costs would be “smoothed” over time by lowering costs in the short term and increasing costs over the long term. The proposal would also involve recovering the interest and/or financing charges required to defer these costs, which might be significant depending upon the interest rates which might actually obtain over the term of the option chosen (terms vary with the options for the longest terms extending to 25 to 30 years).

¹⁷Ontario Planning Outlook: A technical report on the electricity system, IESO (September 1, 2016).

For the purposes of illustration and discussion, the Ministry proposes the following three indicative scenarios for potential GA debt financing:

1. Low GA Financing with future cost limits

- The total GA payment from all ratepayers in 2017 is lowered by \$2.5 billion below the true cost¹⁸ of GA, and is increased at inflation (assumed to be 2% annually) in each subsequent year until the total amount of money borrowed is paid off, including interest / financing charges. In this scenario, the debt is fully paid off by 2034 (*i.e.*, 17 year financing).
- The amount of future GA over-payments would be capped at \$2 billion above the true cost of the GA (the cost of the GA without the added interest / financing charges), in order to limit the risk of large increases in the total costs of electricity in any given year.

2. Moderate GA Financing with future cost limits

- The total GA payment from all ratepayers in 2017 is lowered by between \$3.1 and \$3.3 billion below the true cost of the GA and increased at the rate of inflation over subsequent years until the total amount of money borrowed is paid off, including interest / financing charges, with an anticipated 25 or 30 year financing period.
- The amount of future GA over-payments would be capped at \$2 billion above the true cost of the GA, to limit the risk of large increases in the total costs of electricity in any given year.

3. Moderate GA Financing with future cost limits and delayed increase in payments

- The total GA payment from all ratepayers in 2017 is lowered by between \$1.1 and \$1.4¹⁹ billion below the true cost of the GA, ratepayer payments decrease over a 4 year period such that the average monthly residential bill remains constant in nominal dollars, subsequent ratepayer payments increase at 3% each year until the total amount of money borrowed is paid off, including interest / financing charges, with an anticipated 25 or 30 year financing period.
- The amount of future GA over-payments would be capped at \$2 billion above the true cost of the GA, to limit the risk of large increases in the total costs of electricity in any given year.

¹⁸ “True costs” refers to the costs payments made to generators or counter parties under the terms of contracts to provide generating supply and capacity, and does not include the incurring of additional discretionary financing or interest costs.

¹⁹ While this proposal contemplates borrowing a lower amount than the Low GA financing option, it is treated here as moderate financing because the extended periods of decreased payments and for repayment gives rise to a higher (moderate range) financing cost.

4. Maximized GA Financing without future cost limits

- The total GA payment from all ratepayers in 2017 is lowered by between \$4.4 and \$5 billion and increased at the rate of inflation over subsequent years until the total amount of money borrowed is paid off including interest / financing charges, with an anticipated 25 or 30 year financing period.
- No limit would be placed on the amount charged to ratepayers above the true cost of GA.

ANALYSIS

C. Legal Principles

The principles of constitutional law governing taxes and regulatory charges are reviewed in detail in our previous opinions relating to the GA charge, dated May 17, 2004, November 28, 2008, July 21, 2010 and September 10, 2012. In particular, we refer the reader to a synthesis of the applicable principles of law provided in the memorandum dated November 28, 2008 (at 6-7).

In short, the central task is to determine whether the primary purpose of a levy is, in “pith and substance”, to tax, *i.e.*, to raise revenue for general purposes, or rather, to finance or constitute a regulatory scheme or charge for services directly rendered.²⁰ Unlike a tax, a regulatory charge intended to defray costs must be “ancillary or adhesive to a valid regulatory scheme”.²¹

The Supreme Court of Canada has identified four major *indicia* to be considered in assessing whether a levy is connected to a regulatory scheme: (1) a complete, complex and detailed code of regulation, (2) a specific regulatory purpose which seeks to affect the behaviour of individuals, (3) the existence of actual or properly estimated costs of regulation, and (4) a relationship between the regulation and the person being regulated, where the person being regulated either causes the need for the regulation or benefits from it.²² A consideration of the extent to which those *indicia* are satisfied constitutes the “first step” of the analysis.²³ The Court has explained that a required “second step” of the analysis is that “in order for a regulatory charge intended to defray the costs of a regulatory scheme to be ‘connected’, the fee revenue must be tied to the costs of the regulatory scheme”.²⁴ Courts will not insist that fees correspond precisely to the cost of the relevant service provided there is a reasonable connection between the cost of the service provided and the amount charged.²⁵ Where a sufficient connection between the person paying, the reason for the charge and the amount of the charge is lacking, however, there is a greater risk that the court will conclude the levy is an tax exacted to generate revenue,

²⁰ *Westbank First Nation v. British Columbia Hydro and Power Authority*, [1999] 3 S.C.R. 134 at para. 30.

²¹ *Allard Contractors Ltd. v. Coquitlam (District)*, [1993] 4 S.C.R. 371 at para. 58.

²² *Westbank*, *supra* at paras. 24, 27 and 44; *620 Connaught Ltd. v. Canada (Attorney General)*, [2008] 1 S.C.R. 131 at para. 25.

²³ Not all *indicia* need be present to find a regulatory scheme: *Westbank* at para. 24. Nonetheless, there must be criteria establishing a regulatory scheme and its relevance to the person being regulated: *Connaught* at para. 26.

²⁴ *Connaught* at para. 38.

²⁵ *Eurig Estate (Re)*, [1998] 2 SCR 565 at para 22.

rather than further regulatory goals.²⁶ If the proposed charge were a tax, then to be constitutionally valid it would have to be clearly and unambiguously imposed by a statute originating in the legislature.²⁷

D. Application of Legal Principles

Our previous opinions related to the GA charge concluded that the legislative framework under the *Electricity Act, 1998*, *Ontario Energy Board Act, 1998*, and the extensive set of regulations made thereunder, constituted a regulatory scheme with regulatory purpose that seeks to affect the behavior of individuals and is a complete code of regulation, satisfying the first two indicia (CLB opinion dated May 17, 2004 (at 19) and November 28, 2008 (at 8-9)). The third indicium is also satisfied as there are actual costs of regulation pertaining to providing for adequate generating capacity and conservation, which are financed through the GA.

We focus below on the fourth indicium of a regulatory charge, being whether the GA financing proposal would support a sufficient relationship between the regulation and the person regulated, such that the individual subject to the regulatory charge either causes the need for the regulation or derives a benefit from it.

At the time of writing, the Ministry does not have sufficient particulars to provide a comprehensive assessment of the second step of the tax versus regulatory charge analysis, which is whether there is a sufficient relationship between the future consumer who would pay for today's deferred GA payments, the amount they would pay, and the reason for it. We do provide general guidance on elements of the proposal that could increase or mitigate risk, which would ultimately depend on particulars of the amount that is borrowed, the term of repayment, the relevant assets, their existing contracts, and their useful life expectancy.

Regulatory Connection with the Person Paying

A key indicium of a regulatory scheme is a relationship between the regulation and the person regulated, in which the individual subject to the regulatory charge either causes the need for the regulation or derives a benefit from it. In *Westbank* (at para. 28), Gonthier J. described this indicium as follows:

Finally, the individual subject to the regulatory charge will usually either benefit from the regulation, or cause the need for the regulation: Magnet, *supra*, at p. 459. In *Allard*, *supra*, the gravel trucks caused the need for the repair to the roads; in *Ontario Home Builders'*, *supra*, the developers and the new home-owners caused the need for the new schools. In both cases the individuals being charged also benefited from the regulation.²⁸

²⁶ *Connaught* at para 20.

²⁷ *Eurig* at para. 41.

²⁸ *Westbank*, *supra* at para. 28.

Based on the information that the Ministry has provided, consumers of electricity in the future, cause the need to ensure long-term planning of electricity generation and conservation. As we noted in our previous opinion dated May 17, 2004 (at 22), providing for the reliability of electricity supply, in both the short and long term, is a critical function of the regulatory scheme governing electricity and electricity markets.

Future consumers could also derive a benefit from the continued utility of the assets, the cost of which is passed on to consumers in GA charges. The information provided by the Ministry is that these assets include gas plants and renewable generation assets, and conservation assets, which are anticipated to be paid for prior to the exhaustion of their useful lifespan. Assuming the supplier remains in business, the generation assets would continue to generate electricity and thereby provide an economic benefit to future consumers after they have been paid for, subject to any applicable regulatory change, maintenance and refurbishment needs. The conservation assets that would be paid for by current consumers could also benefit future consumers both through their continued conservation utility to those future consumers and through the deferral or obviation, due to reduced demand, of further investment that would otherwise be necessary to renew or refurbish existing generation and transmission assets.

Even though these generation and conservation assets may not be owned by the Province, their continued useful lifespan beyond the term over which the asset is paid for is a potential benefit to those consumers who would then be able to purchase electricity generated by these assets, without the need to fund the financing of the creation of new generation assets.

While future consumers may benefit from the continued utility of the asset after it has been paid for by current consumers, these costs to current consumers result from normal commercial transactions that merely reflect the commercial marketplace, and do not raise any tax versus regulatory fee issues.

It would also be open to the Government to satisfy the market cost of ensuring generating capacity up front with richer contract prices to incentivize investment in generation capacity in the early period and, instead of passing those costs immediately to the current generation of consumers, to spread the cost over the lifespan of the asset, on the ground that future consumers cause the need for and benefit from that generation asset just as current ratepayers do. However, where a sufficient connection between those paying these charges and the reason for them is lacking, there is a greater risk that the court will conclude the charge is a tax exacted to generate revenue, rather than further regulatory goals.

Legal risk therefore arises, however, if it becomes apparent that the Government is not spreading cost so that it is shared by future consumers who cause a need for and benefit from the assets, but rather is doing so in order to lower the price for current consumers by increasing the price for future consumers. If the proposed financing served to encumber future consumers with a premium payment to cover the GA financing in order to subsidize current ratepayers, unrelated to future benefits, then there would be a moderately high constitutional risk that the financing proposal would result in an unconstitutional tax absent some other regulatory or economic rationale sufficiently connected to the regulatory scheme to maintain the necessary nexus between those who pay and those who cause the need for or benefit from the regulated scheme.

So long as the particular underlying assets have useful life expectancies beyond the terms of their existing contracts, such that future consumers who cause the need for and benefit from this future capacity would share in the cost of financing the required assets, the proposal would pose only a low constitutional risk.

Based on the preliminary information that the Ministry has provided, there is potential for the GA financing proposal to defer costs to future electricity consumers who cause the need for and benefit from the residual (post-contract) utility of the generation and conservation assets. Because some of the assets paid for through GA charges are expected to have continued utility to future consumers who would not pay for them under current contractual arrangements, deferring the cost of the residual value of these assets to future consumers would spread the cost among all consumers who cause the need for and benefit from these generation and conservation assets. The lowest risk approach would therefore be to account the value and useful life expectancy of the assets comprising the GA to determine how much can be reasonably be removed from the current GA and the period in which it should be collected back. You may wish to include this option.

We note the following factors that could impact the assessment of whether there exists the requisite connection with the person causing the need for or benefiting from the regulation.

First, the slide deck mentions that not all generating assets will continue operations at the end of the contract term, meaning that some of these assets would shut down at the expiry of their financing contracts. Having future consumers pay for the costs of generation assets that are no longer producing (*e.g.* the Pickering nuclear generator after it is closed) would lack the requisite connection between the consumers paying for the charge and their causing a need for or deriving a benefit from it, resulting in a greater risk that the proposal would be found to be an unconstitutional tax.

Second, establishing a connection with the person paying the charge will also depend on whether the term of repayment is a reasonable reflection of the expected useful lifetime of the assets. The Ministry is proposing three scenarios that include different options for repayment of the proposed borrowing of funds. The low financing option contemplates a 17 year repayment period, while the moderate and high financing options contemplate either 25 or 30 year repayment periods. The term of repayment is significant because it will impact whether the consumers who bear the burden of repaying the loan will be the same consumers who would benefit from the residual value of the assets.

To illustrate, the Ministry explains the cost of the generation assets are presently being paid for through the GA on the basis of 20 year contract terms, while these assets are expected to continue to benefit consumers beyond their contract terms. Similarly, conservation assets paid for by current consumers will have a benefit to future consumers both through their continued conservation utility and through the deferral or obviation, due to reduced demand, of further investment in generation and transmission assets. In order for the proposed refinancing to actually transfer the GA cost to future consumers who will enjoy the residual benefit of these assets, the term for repayment would have to extend beyond the current contracts' remaining

terms. For instance, if the contracts for the assets had a remaining term of 10 years and the assets had an expected useful life of 17 years, the proposal to borrow against the asset today, with a 17 year repayment term, would legitimately reallocate the cost of the GA asset from present consumers to future consumers who would benefit from the continued utility of the asset.

Conversely, if the contracts have a remaining term closer to 20 years, and a useful life expectancy of 30 or more years, then all things being equal the shorter financing period (e.g., 17 years) would increase constitutional risk, as it would not successfully spread the burden of financing the GA charges among future consumers who cause the need for and benefit from the assets but would otherwise not contribute to their financing. The risk associated with a repayment period that is shorter than the useful life of the asset is reduced if there is a *bona fide* commercial justification for the particular repayment term, such as it being a term that is negotiated with an asset owner (in the case of the original contracts) or the particular repayment period being necessitated by the type of debt that is most prudent to take on (in the case of the financing being used to redistribute the repayment period).

Complicating the two above considerations is that the proposed financing does not concern a single asset under a single contract with a single life expectancy, but many contracts in relation to assets of varying value, useful life expectancy, and remaining terms. To mitigate the risk of an insufficient connection between the amount of the deferred charge, the reason for it, and the future consumers who pay for it, we recommend that amount borrowed and term of repayment be structured to reflect the accounting of the cost of the value of the assets, their remaining contractual terms and expected useful life expectancy, so as to spread the cost of financing the assets as evenly as possible among all consumers who would benefit from these assets.

Third, you advise that under each of the three scenarios proposed by the Ministry, in addition to loan costs, there would be interest borne by consumers until the amount of money borrowed is paid off. The proposal assumes a 5% interest rate. Provided the interest rate charges passed on to consumers reflect the Province's actual cost of borrowing, there would remain a connection in the sense that the real cost of financing the generation asset would be borne by consumers in an amount proportionate to the benefit that they receive.

Finally, the proposal, in two of the three scenarios discussed in the slide deck, to cap future payments toward the GA at \$2 billion above the true cost of the GA, to limit the risk of large increases in the total costs of electricity in any given year, has potential to increase risk. While small adjustments intended to smooth out sharp increases or decreases to the payments in a given year would likely be defensible, a blanket cap that results in future consumers paying for assets that have ceased providing any benefit would be inconsistent with proportionate sharing. In other words, if capping future GA payments (including loan repayment) means that the repayment term of the loan would be extended beyond the reasonably expected useful lifespan of the underlying assets, such that future consumers were required to pay for them after they ceased providing any benefit to the Ontario electricity system, then a court would be more likely to find the requisite connection between the person paying the charge, and the person causing the need for or benefiting from the assets to be lacking.

We would be pleased to provide further assistance as policy options that address the particular amount to be borrowed, the term of repayment, the particular affected assets, their current remaining financing contract terms and their expected useful lifespan becomes available.

We trust that the foregoing is of assistance, and would be pleased to discuss at your convenience.