ONTARIO'S FAIR HYDRO PLAN'S CLEAN ENERGY ADJUSTMENT AND THE OEFC'S DEBT RETIREMENT CHARGE

ISSUE

To provide background and key points in a comparison between the Clean Energy Adjustment (CEA) under the *Ontario Fair Hydro Plan Act, 2017* (FHP Act) and the Debt Retirement Charge (DRC) that was implemented to help service and retire the debt of the former Ontario Hydro and other liabilities.

Commented [MB1]: I understand why this was written this way, but fundamentally this is debt of the former Ontario Hydro.

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Key Points	
• The FHP Act is being implemented in the context of a hybrid electricity market under which generation is regulated or contracted. ○ Global Adjustment (GA) is a portion of the commodity cost of electricity paid by all Ontario electricity consumers. ○ GA refinancing aims to more fairly allocate amongst ratepayers the cost of certain investments in generation assets and conservation that are expected to last longer than their typically 20-year contract terms. ○ The FHP Act reallocates recovery of "clean energy costs" over time in order to more fairly apportion those costs to present and future "specified consumers" (i.e., the class of ratepayers covered by the FHP Act). The "clean energy costs" relate mostly to certain investments in electricity generation assets that are expected to last longer than their typically 20-year contract terms, and to certain conservation and demand management programs that are expected to benefit both present and future ratepayers. The clean energy costs are part of the GA, a component of the cost of electricity). • This reallocation of recovery of the clean energy costs is being established under legislation and a regulatory framework, which	• The 1999 electricity sector restructuring was under the *Energy Competition Act, 1998*, ("ECA") to move Ontario's electricity sector to a competitive structure, including providing for private sector involvement and a market price for the electricity commodity. • The Debt Retirement Charge ("DRC") was provided for under legislation; however, it was not under a regulatory structure (e.g., with no role for the OEB), and the Province did not establish a defined deferral account balance or a particular amount to be recovered under the DRC. The DRC was authorized under the Electricity Act, 1998, until the "residual stranded debt" ("RSD") was retired, as determined by the Minister of Finance. ○ Because of the ECA's purpose was to provide for a competitive market, the actual annual amounts of other dedicated revenues (e.g., PILs, electricity sector dedicated income – "ESDI") to be paid to OEFC was uncertain, since it depended on the successor companies' actual financial performance. Therefore, the timeframe for retiring RSD was uncertain – so the length and total amount of DRC required was uncertain. • The DRC reflects a portion of the disaggregation of the old "bundled rate" of the old Ontario Hydro that included cost recovery related to generation, transmission and central market services, and including

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includes the establishment of a regulatory asset, and a deferral account reflecting the portion of the clean energy costs being reallocated to future “reference periods” (i.e., defined in the FHP Act as six-month periods starting May 1 or November 1, or other periods prescribed by regulation) and the associated financing costs. • The Clean Energy Adjustment (CEA) reflects the recovery of the deferral account balance, with a legal/regulatory structure supporting the ability to recover that balance, over a particular timeframe under the FHA. ○ The total CEA payable in each reference period shall be determined by the Financial Services Manager (i.e., Ontario Power Generation) in accordance with rules provided in the FHP Act and regulations, and recovered from specified consumers. • As a result of the reallocation of clean energy costs, financing is required, resulting in additional gross debt under the FHP Act structure. • The Ontario Energy Board (OEB) shall determine the rates at which specified consumers are invoiced over each reference period, subject to ensuring recovery of the CEA amount for the reference period as determined by the Financial Services Manager.	debt costs. ○ The DRC reflected the break-up of the old Ontario Hydro, vertically-integrated monopoly and its bundled rates into commodity, delivery, central market, and a portion of legacy debt service components. It was not considered a “new” or additional cost for the all-in price of electricity. ○ As such, the intention of establishing the DRC framework was not to shift in time the cost recovery of the old Ontario Hydro debt and other liabilities. • “Unbundling” the rates did not in itself create new debt. Though the estimated liability for non-utility generator contracts became recognized on OEFC’s balance sheet, cost recovery of those contracts had been part of the old Ontario Hydro bundled rates. • The DRC was set by the government, under the *Electricity Act, 1998*, at 0.7 cents per kilowatt-hour for most electricity consumed in Ontario. It is paid to OEFC, and, under an MOU, administered by the Ministry of Finance (originally by the former Ministry of Revenue). • Having the old Ontario Hydro debt and other liabilities managed by OEFC, and the DRC paid to OEFC, with separate, audited financial statements, provided for transparency and accountability. ○ Note: An argument was made back in the 1999 and 2000 period that OEFC’s revenues over time, as dedicated to it under legislation, could be reflected as assets on OEFC’s balance sheet. In the end, this was not the accounting treatment established for OEFC. The Provincial accounting treatment agreed to was to charge the Province’s accumulated deficit for the amount of the stranded debt.

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Detailed Context	

• The CEA arises from the Government's policy to shift recovery of a portion of the clean energy costs to the future in order to relieve specified consumers of some of the burden of paying for investments the benefits of which will continue to accrue to future generations.
 	
• Between 2005 and 2015, Ontario invested more than $50 billion in the electricity system, including $35 billion in electricity generation to ensure the system is cleaner and more reliable. The costs of these investments are funded in part through the Global Adjustment charge on electricity bills. The GA charge includes the costs of electricity infrastructure investments on an ongoing basis. The size and timing of these investments led to significant increases in electricity bills through the GA charge.
 	
• While the majority of the contracted generation contemplated under the FHP Act is for a 20-year term, the generating assets are expected to have ongoing useful life beyond that term, and certain conservation and demand management investments are also expected to benefit future ratepayers, justifying the planned longer timeframe for recovery of associated costs under the FHP Act. The FHP Act will relieve some of the current clean energy cost burden on today's specified consumers and share those costs more fairly, by refinancing a portion of the GA, and recovering costs in the future through a deferral account. This will provide immediate rate relief by spreading a portion of the clean energy costs over the period that benefits are expected to accrue from the investments giving rise to those costs, including spreading the cost of certain electricity investments over the expected lifecycle of the infrastructure that has been built.
	• The OEFC stranded debt arose in 1999 as a result of the restructuring of the electricity sector under the *Energy Competition Act, 1998*.
	  ○ The underlying policy intent was to create competition in the sector, including the break-up of the former Ontario Hydro and creating a tax-payments-in-lieu of taxes level playing field for private and public sector owned electricity companies.
	  ○ The Act also provided for the Debt Retirement Charge (DRC), to help manage the legacy debt and other liabilities of the former Ontario Hydro.
	
	• When the former Ontario Hydro was restructured on April 1, 1999, the Ontario Electricity Financial Corporation (OEFC) was established with the mandate to manage and retire the former Ontario Hydro's debt and other liabilities, totaling $38.1 billion. The $38.1 billion in debt and liabilities had been accumulated in building Ontario's electricity generation and transmission infrastructure.
	
	• A portion of the $38.1 billion could be supported, in the context of a restructured market, by the assets of Ontario Hydro successor companies, in particular OPG, Hydro One and IESO, however, OEFC was left with $20.9 billion in stranded debt. Conceptually, stranding was generated by two factors:
	  ○ "Commercial" stranding, as level-playing field "PILs" were put in place, resulting in the successor companies having less cash flow to support debt, and as the commercial successor companies would have a higher cost of capital {a higher, commercial, return on equity (ROE) – as regulated for Hydro One, and as for comparable competitive generators for OPG}.

Commented [MB2]: Think something is needed here analogous to the $50B in the left-hand column (i.e., cost overruns at Darlington, price freeze in the mid to late 1990s – without that price freeze there is no DRC).

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• In the early years, a portion of the clean energy costs will be refinanced to reduce pressure on today's specified consumers. In later years, in addition to recovering the deferred amounts of clean energy costs, the cost of refinancing will be recovered from specified consumers. This recovery is through the clean energy adjustment (CEA) as established under the FHA Act. It is the amount that will be recovered from specified consumers in the future to pay principal, interest, transaction costs and administrative costs associated with the reallocation of the clean energy costs. • The debt that the CEA will retire, is not pre-existing but arises out of the policy choice to shift a portion of clean energy cost recovery, along with the cost of financing that shift, from current monthly settlements to the future in order to more fairly align the costs with the associated benefits There was an existing policy in place to recover these costs within a 12 month period after payments came due, and that policy has changed to recover these costs within over a 30 year period (or such longer period as may be prescribed under regulations made under the FHP Act).	○ "Competition" stranding, where the projected future commodity price of electricity was estimated to be lower than the former rate-regulated price, such that OPG could support a lower level of debt, and a liability was created with respect to the legacy power purchase agreements (PPAs) with non-utility generators (NUGs). • To allow OEFC to service and retire $38.1 billion in total debt, including the $20.9 billion in stranded debt, the Province established a long-term plan where debt servicing and repayment would be through dedicated revenues from electricity-sector companies. ○ This included dedicating the amounts to OEFC related to the "commercial" stranding: PILs to OEFC and the "Electricity Sector Dedicated Income" in respect of the net income (i.e., ROE) in excess of the Province's financing cost for the equity. ○ As PILs were dedicated to OEFC, they were not considered to be a net pressure on all-in prices, simply replacing a portion of debt-service costs that had been embedded in the old regulated prices of Ontario Hydro. The higher ROE was also effectively recycled too. ○ As of April 1, 1999, the present value of these revenue streams was estimated at $13.1 billion, leaving an estimated $7.8 billion of "residual stranded debt". ○ Due to the uncertainty discussed above, the Act provided for the Minister of Finance to update the RSD determination from time to time. • The Debt Retirement Charge (DRC) on electricity bills was established under the Electricity Act, 1998, to be paid to the OEFC until the residual stranded debt was retired (as determined by the Minister of Finance).

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	○ As this was related to "competition" stranding, which created price room due from the lower projected commodity price, the DRC was not considered to be creating price pressure, but was in effect just a disaggregation of a portion of the debt service costs embedded in the old regulated rates of Ontario Hydro.
Fiscal Impact to the Province	
• Under the FHP Act financing structure, transactions related to clean energy cost refinancing, including CEA payments, will be reflected on the Province's consolidated results through the consolidation of OPG and IESO. Based on the anticipated accounting treatment, the CEA transactions will not have a net impact on the Province's surplus or deficit, annually or over time (at least not materially). ○ Note: OPG's net income is expected to increase by the amount of the interest it charges to the Trust on the debt issued to the Trust funded by the 44% equity injection. That net income increase will provide a fiscal offset to the Province's increased IOD from the Province's borrowings related to the equity injection.	• The DRC, paid by electricity rate payers, is a revenue to the OEFC and in turn the Province upon consolidation. • The DRC increases revenues, and helps offset debt service costs of OEFC (and the Province, on consolidation). • Over time, where OEFC has an excess of revenues (including DRC) over expense, this decreases OEFC's unfunded liability (sometimes called "stranded debt"). Note: Stranded debt is included in the measurement of the Province's net debt
Payment Amounts	
• The CEA payment amount for each reference period will be determined by the Financial Services Manager (i.e., OPG) and is not yet determined. • Once the total CEA payable is determined by Financial Services Manager (i.e., OPG), the Ontario Energy Board (OEB) shall determine	• The Debt Retirement Charge (DRC) is presently and has been paid by most electricity consumers at a rate of 0.7 cents per kilowatt hour.

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the rates at which specified customers are invoiced over the reference period in order to pay the CEA amount.	
Payment End Date	
• Under the FHP Act, electricity rates for the period beginning on July 1, 2017 and ending on April 30, 2018 would be 25% lower for eligible electricity consumers. The FHP Act also intends to hold increases at the rate of inflation for four years. The CEA period would reflect the necessary cost recovery of the deferred GA. • The recovery period as stated in the FHP Act will end on either April 30, 2047 or a later date as may be prescribed in regulation. • Correspondingly the CEA would also end on April 30, 2047 or such later date.	• Initially, under the *Electricity Act, 1998*, the DRC payment period was open ended with the intention to end the DRC once the residual stranded debt is retired. • The estimated retirement of residual stranded debt was subject to uncertainty in forecasting future OEFC results and dedicated revenues to OEFC, which depended on the financial performance of OPG, Hydro One, and municipal electric utilities, as well as other factors such as interest rates and electricity consumption. • As included in the 2014 Budget, the government has removed the DRC cost from residential electricity users' electricity bills as of January 1, 2016. The government introduced legislation, passed on December 10, 2015, *the Budget Measures Act, 2015* to legislate a fixed end-date for the DRC of April 1, 2018, for commercial, industrial and all other users.

APPENDIX

Excerpt from Remarks by Auditor General Bonnie Lysyk to the Standing Committee on Justice Policy on Bill 132 *Ontario Fair Hydro Plan Act, 2017*
MAY 24 ,2017

“The accounting transaction is structured in a complex manner. In simple terms, the government plans to record as an asset the expected recovery of the 25% in electricity costs from future ratepayers that it will borrow for and pay to power producers today. In essence, it is setting up as an asset an accounts receivable that it expects to collect from future ratepayers between 2022 and 2047 that is not yet an accounts receivable because the consumer has not yet used the electricity.

A similar move to legislate accounting to defer costs was proposed with the restructuring of the Ontario electricity sector in the late 1990s. At that time, the government did not want the net impact of the stranded debt, which had already been incurred, to be reflected on the Province’s financial statements. Because it anticipated that ratepayers would pay down this debt, it wanted to create an asset to reflect those future anticipated revenues from electricity ratepayers. This approach would have fully offset the total stranded debt, such that there would have been no net debt impact reflected on the Province’s consolidated financial statements. The Auditor General’s opinion, as stated in our Office’s 2000 Annual Report, was that this [quote] “would have set an unacceptable precedent for government accounting. It would also have represented a departure from one of the central tenets of generally accepted accounting principles—that revenue not be recognized until it is earned.” [end quote] The government heard these concerns and was prudent in making the decision to not create an asset for future anticipated ratepayer payments. I believe those concerns are equally applicable today.”

Excerpt from *Auditor General of Ontario 2000 Annual Report*

“In last year’s Annual Report, I indicated that the government intended to offset Ontario Hydro’s stranded debt with a deferred charge on OEFC’s statement of financial position in accordance with accounting standards for rate-regulated utilities. I further indicated at that time that the details of this accounting had not been finalized. In this year’s audit, we found that the Ministry of Finance had not adequately supported recognition of the deferred charge as an asset. Accordingly, we found it necessary to conduct extensive accounting research. Based on a full assessment of the proposed accounting, an exhaustive review of Canadian and U.S. accounting standards, discussions with ministry staff and external advice, we concluded that the deferred charge could not be recorded as an asset.

The deferred charge approach would have excluded the stranded debt entirely from the measure of the government’s net debt. It would have also excluded the electricity sector’s annual operating income or loss from the measure of the government’s annual surplus or deficit. Failing to recognize an existing liability, particularly one of the magnitude of OEFC’s stranded debt, as well as the ongoing income or loss from a significant government sector because of the expectation that this debt would eventually be discharged by means of future dedicated revenue streams would have set an unacceptable precedent for government accounting. It would also have represented a departure from one of the central tenets of generally accepted accounting principles—that revenue not be recognized until it is earned.

Our research also indicated that certain provisions for loss deferral allowed only for rate-regulated utilities were not applicable to Ontario's situation. Work on resolving this complex issue was not finalized until late October. The final financial statements included the net assets/ liabilities and operating results of the four electricity entities owned by the province, and we concluded that this accounting resulted in a fair presentation of the province's financial position and operating results."

Corporate and Electricity Finance Division
May 31, 2017