Q& A Response – OAG's Report on Ontario's Fair Hydro Plan

Q. Why did the government introduce Ontario Fair Hydro Plan?

The government has been making important investments in a cleaner and more reliable electricity system, but these investments have led to higher bills. Since 2003, nearly $70 billion has been invested in the electricity system, including more than $37 billion in electricity generation to ensure the system is clean and reliable.

Ontario Fair Hydro Plan (OFHP) is delivering the single-largest reduction in electricity rates in the province's history. OFHP has introduced new measures to lower electricity bills by 25 per cent on average for residential consumers and will hold increases to the rate of inflation for four years. As many as half a million small businesses and farms are also benefitting from a reduction.

In developing the policy to refinance the Global Adjustment (GA), the government considered a range of implementation options and consulted with legal, accounting, financial and energy sector third-party experts to provide advice and ensure due diligence was completed.

GA refinancing is designed so that deferred costs are borne by the rate-base, as the beneficiaries of the electricity system, and not the tax-base.

OFHP operates under a financial and accounting framework that is appropriate for the intended purpose and in accordance with Public Sector Accounting Standards (PSAS) and ensures that the fairness goals underlying the program are achieved in a cost-effective manner.

Q. The Auditor General and the Financial Accountability Office both suggest that the cost of borrowing will be more expensive than traditional government borrowing? Is this true?

In the development of Ontario's Fair Hydro Plan, the government made the policy decision that deferred electricity system costs should be borne by the rate-base and not the tax-base.

Based on this policy decision, it was decided that the debt obligation would be recognized as a regulatory asset that would be sold and securitized. This design appropriately aligns the costs and benefits within the group of eligible consumers.

Ontario Power Generation (OPG) was identified as the Financial Services Manager responsible for the financing plans and the financing entity (i.e., Fair Hydro Plan Trust) that will manage the debt obligations. OPG has the necessary financing and commercial expertise to assist with refinancing the Global Adjustment (GA) and will ensure that it is done in an efficient and cost-effective manner.

OPG has a demonstrated track record in the financial markets with its Corporate Debt platform, private placement of insurance linked bonds, participation in securitization program and highly successful project debt issuances tied to new hydroelectric developments. The innovative, cost saving and precedent setting aspects of these structures have resulted in international recognition.

With respect to the $4 billion figure referenced by the Financial Accountability Office (FAO) in its May 2017, it should be noted that the FAO's report was based on initial Ministry of Energy estimates from March 2017. Subsequent analysis conducted by the Ministry of Energy refined a number of variables, including the cost of borrowing and electricity system cost forecasts.

Accumulated interest is projected to be considerably less than estimated in the FAO's May 2017 report. Peak debt for the program has been revised down substantially since May, from $27.7 billion to $18.5 billion.

In addition, a number of variables, including interest rates, electricity demand and electricity costs, will vary over the 30-year life of the program and cost estimates will continue to be revised to reflect these changing conditions. The total estimated cost of the program has already been revised downwards substantially to reflect revised inputs.

The government will continue to identify and implement initiatives to take costs out of the electricity system, which would reduce the cost of the GA refinancing program. Further details will be released in the upcoming 2017 Long-Term Energy Plan.

Q. Have the Ministry of Energy's estimates for "peak debt" and "total interest costs" related to Ontario's Fair Hydro Plan (OFHP) changed? I understand that the Office of the Audit General (OAG) has asked what are the factors that resulted in the changes in estimates from March 1 to August 31?

The Ministry of Energy's estimates of peak debt for OFHP decreased between March 1, 2017 and August 31, 2017 from $27.7 billion to $18.5 billion. The Ministry estimates of total interest cost also decreased from $25.1 billion to $18.3 billion.

The revised estimates are the result of the following factors:

- The Independent Electricity System Operator (IESO) updated its long-term cost projections for the electricity system and residential bills;

- The Ontario Energy Board (OEB) provided "actual data" with respect to residential bills for the May 1, 2017 to April 30, 2018 period; and

- Based on expert third-party advice the interest rate assumptions for OFHP were updated (i.e., from 5% down to 4.5%).

In addition, for the August 31, 2017 estimate, the Ministry converted debt and interest amounts from calendar year to Regulated Price Plan (RPP) periods.

Q. In the development of Ontario's Fair Hydro Plan, did the government set up the financing structure intentionally to keep it off government books?

No. Global Adjustment (GA) refinancing is designed so that deferred costs are borne by the rate-base, as the beneficiaries of the electricity system, and not the tax-base.

GA refinancing operates under a financial and accounting framework that is appropriate for the intended purpose and in accordance with Public Sector Accounting Standards (PSAS) and ensures that the fairness goals underlying the program are achieved in a cost-effective manner.

Q. Why is the government using Ontario Power Generation (OPG) as a borrowing agent for Ontario's Fair Hydro Act? Would it be easier to use a traditional government borrowing agent like the Ontario Financing Authority (OFA)?

Ontario Power Generation (OPG) has the necessary financing and commercial expertise to assist with refinancing the Global Adjustment (GA).

OPG currently manages approximately $20 billion in segregated nuclear funds to manage nuclear liabilities, and, is an electricity sector entity regulated by the Ontario Energy Board (OEB) with extensive experience with regulatory deferral and variance accounts.

OPG also has the breadth and demonstrated track record in the financial markets with its Corporate Debt platform, private placement of insurance linked bonds, participation in securitization program and highly successful project debt issuances tied to new hydroelectric developments. These financing initiatives have been well received by investors at a reasonable cost to OPG. The innovative, cost saving and precedent setting aspects of these structures have resulted in international recognition.

OPG has developed solid investor relationships and has a large investor base in the structured finance space that would be the target market for financing Ontario's Fair Hydro Plan initiative. For example, Lower Mattagami project financing attracted a broad investor base of ~80 institutional investors, including major investors in the Canadian power and utility bonds market.

In terms of administration, OPG is currently managing its own Corporate public debt program and three project financing programs totalling more than $2 billion and two commercial paper programs.

Finally, OPG's Treasury functions are well positioned given their management of existing multiple debt programs.

Q. The Financial Accountability Office (FAO) suggested that using Ontario Power Generation as the borrowing agent will cost $4 billion more?

The $4 billion figure was an estimate made by the Financial Accountability Office (FAO) based on initial Ministry of Energy estimates from March 2017. Subsequent analysis conducted by the Ministry of Energy refined a number of variables, including the cost of borrowing and electricity system cost forecasts.

The Ministry of Energy's estimates of peak debt for OFHP decreased between March 1, 2017 and August 31, 2017 from $27.7 billion to $18.5 billion. The Ministry estimates of total interest cost also decreased from $25.1 billion to $18.3 billion.

The FAO report itself concludes by saying "the FAO's estimates are subject to many assumptions and uncertainties (…) Fiscal impact may differ significantly from the FAO's estimates."

In addition, a number of variables, including interest rates, electricity demand and electricity costs, will vary over the 30-year life of the program and cost estimates will continue to be revised to reflect these changing conditions. The total cost of the program has already been revised downwards substantially to reflect revised inputs.

The government will continue to identify and implement initiatives to take costs out of the electricity system, which would reduce the cost of the GA refinancing program. Further details will be released in the upcoming 2017 Long-Term Energy Plan.

Q. Do you disagree with the FAO on financial costs?

The $4 billion figure was an estimate made by the Financial Accountability Office (FAO) based on initial Ministry of Energy estimates from March 2017. Subsequent analysis conducted by the Ministry of Energy, refined a number of variables, including the cost of borrowing and electricity system cost forecasts.

Based on updated analysis, the total interest is projected to be considerably less than estimated in the FAO's May 2017 report. For example, peak debt for Global Adjustment (GA) refinancing has been revised down substantially since May 2017 from $27.7 billion to $18.5 billion. The Ministry estimates of total interest cost also decreased from $25.1 billion to $18.3 billion.

The Ministry of Energy's latest estimates reflect the best available information regarding the parameters that impact OFHP cost (e.g., electricity bills, consumption, etc.) and are more likely to reflect how OFHP will progress over time.

Q. The OAG's report claims that consumers will pay an additional $4 billion in interest costs over the life of OFHP since OPG and its Financing Entity will pay a higher rate of interest compared to the Province. Why not have the Province borrow for the OFHP?

The policy objective of OFHP is to more fairly allocate the cost to ratepayers over the useful life, not the contractual term, of the electricity generating assets. Therefore, it was a primary policy objective to ensure that the costs are borne by the beneficiaries of the electricity system – the ratepayers – not the tax-base.

We believe it is appropriate for ratepayers to pay for the financing of electricity assets. The rate-base has a different risk profile than the tax-base, which would be reflected in different interest costs. Having the rate-base pay is not a new policy, for example Hydro One has borrowed in the capital markets since the early 2000s.

The $4 billion figure in the Office of the Auditor General's report was sourced from the FAO's May 2017 report and is important to note, that the FAO's calculation was based on preliminary estimates of the program when peak debt estimates for the thirty year program were substantially higher and interest costs were forecast to be higher than current projections.

Q. Why did the IESO change its accounting practices?

The Independent Electricity System Operator (IESO) began recognizing its market accounts' assets (i.e., amounts due from power distributors) and liabilities (i.e., amounts due to power producers) in their financial results.

This accounting change was accepted by IESO's independent external auditor, which issued an unqualified, or "clean," audit opinion. These accounting changes were highlighted in IESO's 2016 annual report, which was published online in March 2017.

The IESO has chosen to recognize these markets accounts on its books for transparency reasons, as it better reflects its net financial position on behalf of IESO-administered markets at year-end.

Further, this accounting is consistent with the presentation used previously by the Ontario Power Authority (which was merged with IESO on January 1, 2015) in its financial statements.

Additionally this accounting change has been supported by the professional accounting staff of the Office of the Provincial Controller.

This change has no impact to the province's annual deficit, net debt, accumulated deficit or on the ratepayers of Ontario.

We will continue to work with the Auditor General to build on the government's track record of responsible fiscal management and high quality financial reporting.

Q. Why did the government not use the Canadian Public Sector Accounting Standards (PSAS)? How was Ontario's Fair Hydro Plan (OFHP) financing structure determined?

The Province's financial statements are prepared in accordance with Canadian PSAS and will follow PSAS in accounting for the transactions resulting from OFHP in 2017-18 as well as in the following years. Presenting its financial statements in accordance with PSAS results in transparent financial reporting for the Province of Ontario.

PSAS is, however, silent on the recognition, measurement, presentation or disclosure of rate-regulated activities. In absence of a clear position on an issue, standard accounting practice dictates that an entity should consult other accounting standards. In this case, the Independent Electricity System Operator (IESO) consulted US GAAP, the accounting framework in North America that provides the most developed guidance on rate regulated operations.

This financing structure is similar to several jurisdictions in the U.S., and uses a form or securitization that is commonly used in the financial markets. It ensures the impact of the plan will be transparent. Under this system, credit rating agencies, securities regulators and the public at large get full information and full reporting of the impacts of the OFHP that are visible and specific.

Q. What is the Global Adjustment (GA)?

The Global Adjustment (GA) is a mechanism that recovers certain electricity system costs, such as capital costs incurred by generators. The GA is calculated by the Independent Electricity System Operator (IESO) based on the difference between the market price for electricity, which represents the marginal cost of electricity production, and rates paid to regulated and contracted generators to ensure they can recover their fixed costs. It also accounts for costs associated with running conservation programs in the province.

GA has been an important factor in providing stable prices while ensuring that sufficient generating capacity is in place to deliver a reliable supply of electricity.

GA pays for the bulk of the recent investments in the electricity system. The majority of the province's electricity generators operate under 20-year contracts. Third-party experts have confirmed that many of these generators will be able to continue to operate beyond the end of their contract. This means that generating assets are expected to have ongoing useful life and benefit future ratepayers by reducing the need to finance the development of new generating assets.

Refinancing the GA is providing significant and immediate rate relief by spreading the cost of electricity investments over the expected lifecycle of the infrastructure that has been built. This more fairly shares the cost of our investments across the generations of electricity ratepayers who will benefit from them.

Q. Some say you are unfairly placing the burden of debt on future generations through things like Ontario's Fair Hydro Plan, how do you respond?

Future generations will be paying their fair share for a system they will be benefiting from in their lifetime. Not only will they benefit from a reliable electricity system, but from the cleaner air from the reduction of coal-fired generation.

Ontario's Fair Hydro Plan acts much like taking out a new mortgage – providing much-needed relief now by spreading costs across the life of our assets. Current ratepayers are paying less now, and future ratepayers will in turn help to pay for their fair share of the significant investments that we've made to build a clean and reliable electricity system. This more fairly shares the cost of our investments across the generations of electricity ratepayers who will benefit from them.

Moving forward, Ontario is developing its 2017 Long-Term Energy Plan (2017 LTEP) which will focus on continuing to put downward pressure on electricity bills over the long term. Our robust electricity supply puts us in a good position to improve efficiency, increase transparency and enhance opportunities for innovation and competition to further reduce system costs. That is why Ontario's Fair Hydro Plan includes a commitment to improving sector efficiency and modernizing Ontario's electricity market, building on the collaboration of the Independent Electricity System Operator (IESO) and the Ontario Energy Board (OEB).

For example, IESO's Market Renewal initiative will result in a more efficient marketplace with competitive and transparent mechanisms that meet future system needs at the lowest cost. The initiative is expected to save up to $5.2 billion over a 10-year period and forms a key component of Ontario's plan to ensure the affordability of electricity in the longer term.

Q. Who was involved in the policy and implementation process to meet the mandate?

Senior officials and staff from several departments and agencies, led by the Ministry of Energy, collaborated to plan a structure, identify risks, make decisions and take other actions to meet the mandate.

The senior officials and staff were from:

- Ministry of Energy;
- Ministry of Finance;
- Treasury Board Secretariat;
- Office of the Provincial Controller;
- Cabinet Office;
- Ontario Financial Authority (OFA);
- Independent Electricity System Operator (IESO); and
- Ontario Power Generation Inc. (OPG).

In development and implementation of Global Adjustment (GA) refinancing, the government considered a range of implementation options and consulted with legal, accounting, financial and energy sector third-party experts to provide advice and ensure due diligence was completed.

Response prepared by TBS as Part of the Minister's Speaking Points

Q. How do you respond to the Auditor General's claim that the government ignored warnings regarding a potential adverse audit opinion of Ontario's public accounts?

The government's financial statements are prepared in accordance with Public Sector Accounting Standards (PSAS), and will continue to follow these standards for the transactions resulting from Ontario's Fair Hydro Plan (OFHP) in 2017-18 and in future years.

In regards to rate-regulated accounting, PSAS are silent on the use of regulated accounting:

- PSAS acknowledges that it does not provide guidance on all possible transactions and notes that it is necessary to refer to other sources of guidance that are consistent with the PSAS framework; and
- US GAAP, with the most developed guidance on rate-regulated accounting, is the appropriate guidance to reference.

Many entities in Canada, including OPG and Hydro One use rate-regulated accounting:

- The OAG can refer to the CPA Canada research study that was shared.
- Rate-regulated accounting is well understood in the electricity sector.
- Six other IESO like entities in other North American jurisdictions recognize the economic effects of rate-regulated accounting (i.e., AESO, IEO, NYISO, PJM and ERCOT)

IESO management, IESO's Audit Committee, IESO's Board of Directors, IESO's external auditor and the Office of the Provincial Controller all support the use of rate-regulated accounting by IESO.

In the development of OFHP, the government consulted with several third party advisors in the application of accounting standards. This is normal course of business governments take for complex transactions.