TORYS LLP

MEMORANDUM

CONFIDENTIAL DRAFT - FOR DISCUSSION PURPOSES ONLY

Re High Level Summary of Fair Hydro Deferral Mechanism

Date March 29, 2017

Introduction

This summary is for discussion purposes only. It has been prepared and continues to be updated by Torys LLP on behalf of and in consultation with OPG in an effort to facilitate discussion towards a shared understanding among key stakeholders of the key elements and mechanics of the Fair Hydro Deferral Plan, as well as to support and assist in communicating legislative and regulatory requirements to the Ministry of Energy.

High Level Summary

1. The OEB will determine RPP prices for each of the relevant periods under the Fair Hydro deferral program in a manner that achieves the stated objectives of the program, as follows:

   a) By May 15, 2017, the OEB shall determine new RPP prices that are to come into effect on June 1, 2017. In setting the new RPP prices, the OEB shall apply a reduction to the RPP prices that it would otherwise have determined pursuant to s. 79.16 of the *Ontario Energy Board Act*, which reduction, together with the 8% reduction provided to RPP and other eligible customers under the *Ontario Rebate for Electricity Consumer Act, 2016* (OREC), will result in a total bill impact for RPP **[NTD: and other OREC-eligible]** customers equivalent to a 25% reduction. The OEB shall calculate the new RPP prices, for purposes of achieving such total bill reduction, based on a typical or "proxy" OREC-eligible customer. The new RPP prices shall remain in effect for an initial period of 5 months. **[NTD: Normally, OEB sets RPP prices every 6 months, for May 1 and November 1. As we are aiming for June 1 implementation of the reduced prices, it is proposed that the initial period would be 5 months to enable a return to the May 1/November 1 schedule for re-setting RPP prices. Also need a mechanism to instruct or require OEB to delay re-setting RPP prices from May 1 to June 1, 2017. However, we understand that there has been some discussion that the OEB may be able to set the new RPP prices, reflecting the additional 17%**

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reduction, in its April 2017 re-setting of the RPP, to take effect May 1. If this is achievable, then the timelines described herein would be shifted accordingly]

b) The OEB shall determine by October 15, 2017 new RPP prices that are to come into effect on November 1, 2017. In setting new RPP prices for November 1, 2017, the OEB shall apply a reduction in the same manner as described in paragraph 1(a), above, with the result being a total bill impact for RPP **[NTD: and other OREC-eligible]** customers equivalent to a 25% reduction from the RPP prices that the OEB would otherwise have determined pursuant to s. 79.16 of the *Ontario Energy Board Act*. These prices shall remain in effect for a period of 6 months.

c) The OEB shall determine new RPP prices by April 15 and October 15, to come into effect on May 1 and November 1, in each of 2018, 2019, 2020 and 2021. In setting new RPP prices for each of these periods, the OEB shall determine and apply a reduction substantially in the manner as described in paragraphs 1(a) and 1(b), above, except that such reductions shall be partially offset by annual inflationary increases of CPI to a maximum of 2%, with the result being a total bill impact for RPP **[NTD: and other OREC-eligible]** customers that is equivalent to an inflation-adjusted 25% reduction from the RPP prices that the OEB would otherwise have determined pursuant to s. 79.16 of the *Ontario Energy Board Act*.

d) The OEB shall determine new RPP prices by April 15 and October 15, to come into effect on May 1 and November 1, in each year from 2022 to 2047 pursuant to s. 79.16 of the *Ontario Energy Board Act*. In setting new RPP prices for each of these periods, the OEB shall not apply the reductions described in paragraphs 1(a) and 1(b) above, nor shall it be limited by the annual inflationary increase described in paragraph 1(c) above. Rather, the OEB shall determine and apply increases to the RPP prices that it would otherwise determine pursuant to s. 79.16 of the *Ontario Energy Board Act*, which increases shall ensure full recovery of the regulatory asset(s) by the Financing Entities during the 2022 to 2047 period, as further described below, [subject to the incremental change to the total bill for RPP **[NTD: and other OREC-eligible]** customers being no greater than an increase of 10% from one RPP price period or year to the next]. **[NTD: We understand that a cap in the increase to electricity bills after the initial 5-year period is under consideration. OPG has advised that this will be problematic and if a cap is required, this will require further discussion.]** Consideration should be given as to whether LDCs should be required to collect the amounts needed for recovery of the regulatory assets from their consumers using fixed fees applicable to each customer connection for members of the applicable customer class. This is proposed on the assumption that it would provide greater certainty of recovery as compared to a volumetric charge in the face of declining consumption, as well as to be consistent with the move towards fixed distribution rates.

[NTD: We understand that there are discussions regarding a potential mechanism to determine bill increases for Years 6 to 10 (i.e. after the cap on increases at the rate of inflation has expired). These will be critical years for maintaining financing

capability (as after Year 10, it is expected that principal will start to become repayable). The process that is under discussion would involve an assessment of the remaining financing capacity for the program at the time (i.e. at the end of Year 5), based on the amount of debt incurred, market conditions, forecasts of energy production/consumption and prices, rating agency requirements, etc. A straight-line *minimum* % increase in the bills would be calculated for those years and worked into RPP for those years. This potential mechanism is not otherwise reflected in this high level summary.]

2. The IESO will determine the differences between the amounts collected from eligible customers on the basis of the (reduced or increased, as applicable) RPP prices determined by the OEB, and the amounts that otherwise would have been collected from those customers (had the reductions or increases attributable to the Fair Hydro deferral program not been applied), for each of the relevant periods under the program. In periods where these differences represent a shortfall in the amounts collected, such shortfalls are the deferred principal amounts that will be recorded in a deferral account as a regulatory asset for future recovery and, in periods where these differences represent a surplus in the amounts collected, such surpluses are the amounts that will be used to repay the regulatory asset(s), as follows:

    a) With respect to the RPP prices to be established by the OEB under paragraph 1(a), above, Local Distribution Companies ("LDCs") will apply such prices effective from June 1, 2017, and reflect such prices in customer bills that would be issued in mid-June 2017. In early July 2017, using the IESO Portal, LDCs will report to the IESO the variances between their actual cost of power for June 2017 as invoiced by the IESO and the amount paid by their RPP **[NTD: and other OREC-eligible]** customers for the same volume of electricity based on the (reduced) RPP prices set by the OEB. Applying its existing process, the IESO's Market Settlement group will advise IESO's Treasury group as to the total +/- RPP balance that will go into the RPP Variance Account due to volumetric differences between forecast and actual electricity demand. These variances will be accounted for when the OEB next resets RPP prices, which occurs every 6 months. Under its existing process, the IESO will also determine the total amount of the variances that are attributed to the OREC. The IESO will receive funds from the Province equivalent to this OREC-related variance, which the Province has set aside for this purpose, and the IESO will use those funds to reimburse LDCs (as well as Unit Sub-Metering Providers) for their respective shortfalls attributable to the OREC. Through a new process, the IESO will determine the total amount of the variances that are attributable to the Fair Hydro deferral program for the month. This amount, which represents the total amount of the variance between the actual cost of power for RPP **[NTD: and other OREC-eligible]** customers and the amounts paid by those customers, attributable to the reductions applied by the OEB other than for the OREC, will be recorded as the "Monthly Deferral" in a "Fair Hydro Deferral Account", perhaps in a sub-account for June 2017. By July 10, 2017 the IESO will notify the Financing Entity (described below) of the balance recorded in the subaccount for June 2017 and the Financing Entity will prepare for the purchase of this regulatory asset (being the right to record and recover amounts in the subaccount, together with associated financing, interest and related costs) from the IESO, which purchase will occur by the end of July 2017. The IESO will receive payments from LDCs on July 12 and must remit payments to market participants and other program participants by July 14, as well as to other market participants under IESO contracts by the end of the month. These may need to include payments to LDCs, transmitters and others to ensure they are kept whole in respect of their OEB-approved distribution, transmission and other charges that have been affected by the reduction in the total bill for eligible customers. The IESO will use funds from collections, as well as draws from its bank facility, to make these payments. As described further, below, the IESO will sell the Fair Hydro Deferral Account to the Financing Entity and use the proceeds from the sale to repay the draws on its bank facility.

b) For each month from July 2017 to April 2022, a similar process as described in 2(a) above shall be applied. The LDCs will report, using the IESO Portal, the differences between their actual cost of power per IESO invoices and the amounts they recover for the same volumes through RPP prices set by the OEB and applicable in the month. The IESO will determine the total variances and attribute those variances to the RPP Variance Account for volumetric differences, the OREC and the Fair Hydro deferral program. Variances attributable to the Fair Hydro deferral program will include (i) principal, (ii) interest, (iii) financing costs, and (iv) operating costs paid or payable by a Financing Entity which are not receivable due to the RPP and OREC amounts set by OEB under the Fair Hydro deferral program. The amounts attributable to the Fair Hydro deferral program will be recorded as the Monthly Deferrals in the Fair Hydro Deferral Account, in sub-accounts for the corresponding months. By the 10th day of the following month, the IESO will notify the Financing Entity of the balance recorded in the sub-account for the relevant month and the Financing Entity will prepare for the purchase of this regulatory asset from the IESO, which purchase will occur by the end of that month. The IESO will borrow from its bank facility in order to meet its obligations with market participants and contracted parties. On selling the regulatory asset, the IESO will use the proceeds to repay its draws on the bank facility.

c) For each month from April 2022 to April 2047, a similar process as described in 2(b) will be applied, except that, as a result of the RPP prices determined by the OEB under paragraph 1(d) above, the LDCs will report to the IESO surpluses in the amounts they recover from eligible customers relative to the cost of power invoiced for the month from the IESO. The IESO will determine the total surplus of the amounts collected by LDCs, pay those amounts to the Financing Entity and reduce the balance(s) in the Fair Hydro Deferral Account accordingly. **[NTD: Consider how to deal with the fact that the accumulation of surpluses may not be even and may not match the debt repayment schedules]**

d) In determining increased RPP prices so as to ensure full recovery of the regulated asset(s) by the Financing Entities during the 2022 to 2047 period, the OEB shall rely on the information provided by the Financing Entities and the IESO. In particular, by 2022 all principal and interest amounts due and owing, as well as financing costs incurred, will be known as it relates to debt already issued by a Financing Entity. The Financing Entities will have a right to recover these amounts over the remaining 25 years of the program. The amounts would be amortized over this period and the OEB will be required to apply such amounts to

RPP prices over the 25 year period, subject only to any cap on annual bill increases that may be required by the legislation (in which case the amounts that cannot be recovered in a particular year shall become the subject of new Monthly Deferrals and be recorded by IESO in a Fair Hydro Deferral Account).

[NTD: Need to clarify and distinguish treatment of the different groups of costs: (a) principal, (b) interest, (c) financing – legal, dealer, credit rating, etc., and (d) operating – OPG, trustee, 3rd party service provider. There are also differences between IESO interest costs on short term borrowing from its bank facility vs. Financing Entity interest costs. To what extent are they rolled into the deferral accounts vs. paid monthly? To what extent are they subject to OEB review?]

3. OPG shall establish and control one or more entities (each, a "Financing Entity") whose primary purpose is to purchase regulatory assets, consisting of the right to record and recover Fair Hydro deferral amounts (the "Fair Hydro Regulatory Assets"), from the IESO and fund such purchases and the Financing Entity's operating costs by issuing debt secured by a first priority security interest over such Fair Hydro Regulatory Assets. Although OPG will control each Financing Entity, to support bankruptcy-remoteness the legislation should provide that no Financing Entity may be wound up, liquidated or dissolved until one year after all of its debt has been repaid, unless the Minister (or Cabinet or the OEB – anyone other than OPG) approves. **[NTD: The debt incurred by the Financing Entities will need to be incurred such that the operating business and its assets (in particular the regulated assets) are ring fenced, i.e. that there is no recourse to the generating assets and OPG's regulated business is not subject to or affected by any debt covenants. Otherwise, the regulated business will be affected and the OEB will have the ability to indirectly review all debt, which will affect OPG's revenue requirement when it sets payment amounts under section 78.1]**

4. The IESO will fund any shortfall in the amount that it collects from eligible customers caused by Monthly Deferrals from its own financing sources, but once each month it will sell the newly created Fair Hydro Regulatory Asset to a Financing Entity for the amount recorded in such Account. It is expected that the Financing Entity would fund each purchase of a Fair Hydro Regulatory Asset through short term financing facilities and once a sufficient amount of Fair Hydro Regulatory Assets had been accumulated the Financing Entity would refinance the short term debt with a long term bond issuance (subject to market conditions). To enable this, it will be important that the legislation clearly and expressly provide that the Financing Entities may aggregate and disaggregate the Fair Hydro Regulatory Assets that they purchase from the IESO (or from one another) for purposes of financings and for purposes of eventually recovering amounts from ratepayers. The Financing Entity through its manager, OPG, shall determine the characteristics of the financings it undertakes. A Program Advisory Committee will be established with representatives from OPG, IESO and the Province. The Program Advisory Committee will review the financing strategy to be followed by the Financing Entities, having regard to the policies of the government of Ontario in respect of the Fair Hydro deferral program, the costs of undertaking financings and the prevailing conditions in the capital markets.

5. The IESO will enter into a master sale and servicing agreement ("**MSSA**") with a Financing Entity which will provide for the monthly sale by the IESO of the right to **[record and]** recover (and all incidental rights relating to) the Fair Hydro Regulatory Assets.[1] The legislation will provide that upon each purchase of Fair Hydro Regulatory Assets by a Financing Entity, such Financing Entity shall be entitled to collect from a specified category of customers **[Note: Consider if this category should be hard wired into the legislation or determined by Regulation]** all amounts recorded in the deferral account associated with the purchased Fair Hydro Regulatory Assets together with all costs of the Financing Entity related to borrowing costs and operating costs until all debt of the Financing Entity incurred to fund the purchase of the Fair Hydro Regulatory Assets (including all subsequent refinancing of such debt) and all operating costs of the Financing Entity have been paid in full. Such recovery right shall be deemed by legislation to be a "Regulatory Asset". In making an order for the recovery of the Regulatory Asset **[NTD: Consider whether the OEB has to make an order for recovery of the regulatory asset. This could potentially be fulfilled through the RPP mechanism, which the OEB is bound by through regulation]**, the OEB shall be required to:

   a) accept the balance recorded in the deferral account associated with the Fair Hydro Regulatory Assets, including any subaccounts maintained thereunder, the cost of financing **[and the costs of operations]** reported to the OEB from time to time by OPG; **[NTD: TBD if OEB will have oversight over costs of operations. If so, there is a need to determine who would ultimately be responsible for costs incurred if OEB rejects any of these costs.]** and

   b) issue such orders without a hearing, with the ability to hear the matter through delegated authority and within a specified timeframe (or, in the alternative, the OEB Act could allow the OEB to choose not to have a hearing given it is administrative in nature or at most conduct a written hearing).

6. When establishing the commodity price for electricity for eligible customers, the OEB shall be required to take into account the balance recorded in the Regulatory Asset as reported to the OEB by the Financing Entity (through OPG as its manager). If any legislative or regulatory amendment is required for this purpose, it should be drafted generally so that even if there are future changes to the RPP scheme, those changes would not affect the GA deferral mechanism.[2] **[NTD: Though OEB sets commodity prices for RPP customers, does it also do so for OREC-eligible customers that are not RPP customers? If not, how do GA deferrals get reflected in such customer bills?]**

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[1] To ensure these agreements are not subject to review by the OEB as part of the IESO's administrative rate proceeding, the Electricity Act should deem each such agreement to be a prudent contract (similar to the current provision for the IESO entering into a supply contract on the Minister's direction).

[2] Consideration should be given to whether the OEB will need to amend its "Regulated Price Plan Manual" which sets out in detail how it will go about calculating RPP prices based on the regulation.

7. The Financing Entity will enter into a trust indenture with a trustee for the benefit of all creditors of the Financing Entity (the "Indenture Trustee") pursuant to which the Financing Entity will grant to the Indenture Trustee security over all of its assets (which will be comprised of the Regulatory Assets and perhaps specific reserve or liquidity accounts) as security for all of its obligations to all of its creditors. The Financing Entity may have several sources of funds (credit agreements, commercial paper, medium term notes, long term bonds, as well as hedging programs) all of which will be secured under the trust indenture. The trust indenture will provide for a priority of payments to all creditors that will be binding on all creditors. **[NTD: This proposal is significantly different than the "pure ABS" model used in the United States where each separate series of bonds is backed by its own dedicated regulatory asset. The proposal in this paragraph results in the Financing Entity being a hybrid between an issuer of asset-backed securities and a corporate issuer. This will have securities law implications in Canada and the U.S. that will have to be examined and will likely also have ratings implications (which probably could be addressed by ensuring that each Financing Entity has sufficient credit enhancement (beyond the statutory true-up mechanism) and liquidity in support of the rated debt. One alternative that may be worth considering would be to have one Financing Entity ("Short Term Trust") to issue short term debt, which Financing Entity would enter into the MSSA with IESO, and a second Financing Entity ("Long Term Trust") that would be used solely for issuing long term debt in the public or private capital markets. The proceeds of each series of bonds issued by Long Term Trust would be used to purchase a portion of Short Term Trust's Regulatory Asset which would then be dedicated to funding the repayment of the related series of bonds issued by Long Term Trust, making the bond issuance by Long Term Trust closer to the U.S. precedent transactions.]**.

8. The legislation would have to provide for certain matters in order for a Financing Entity to be able to issue debt having the highest possible rating from rating agencies:

    a) If a sale agreement relating to the sale of Fair Hydro Regulatory Assets (either from IESO to a Financing Entity or between Financing Entities) describes the transaction between the parties as a sale, then such transaction shall conclusively be a sale for all purposes and may not be re-characterized or found by a court to be a loan or any other arrangement.

    b) Since the Fair Hydro Regulatory Assets are personal property (as opposed to real property) which do not neatly fit within the scope of the *Personal Property Security Act* (Ontario), the assignment and granting of a security interest over such assets shall be governed by the legislation through which the Fair Hydro deferral program is being implemented, and that legislation will provide for the perfection and priority of such assignments and security interests, notwithstanding any provisions of the PPSA or any other provincial statute.

    c) The legislation will provide a "Provincial Pledge" modelled on the same pledge provided by states in analogous U.S. legislation.

9. Any capital required by a Financing Entity to purchase Regulatory Assets that it is unable to raise from capital markets or private debt markets shall be provided by ■. **[TBD]**

10. The IESO shall agree to service the Regulatory Assets on behalf of each Financing Entity at no additional charge. In such capacity the IESO shall ensure that all LDCs (as well as Unit Sub-Metering Providers and the IESO in respect of eligible market participants, as applicable) include the relevant amounts required to be billed for all Regulatory Assets. The IESO will be responsible for overseeing the billing, collecting and remitting of such amounts to the Financing Entities. The legislation shall require the Province to appoint a successor to carry out the duties of the servicer in the event the IESO is restructured, dissolved or becomes insolvent. **[Note: Consider if the Province can provide a "performance guarantee" to ensure that the IESO (or its successor) will perform its servicing duties]**.

11. The rate setting process described in paragraphs 1 and 2 will also be used as a "true-up" procedure to ensure that underfunding or overfunding of debt service and operating costs of each Financing Entity will be taken into account during each semi-annual RPP rate setting process administered by the OEB.

12. Each Financing Entity shall have the right pursuant to legislation to record as part of its Regulatory Asset, the administrative costs and fees incurred by the Financing Entity, including amounts paid to OPG for purposes of administering the Financing Entity and any return on investment payable by the Financing Entity in respect of OPG's capital invested in the Financing Entity.

13. Each Financing Entity shall have the right pursuant to legislation to recover the prudently incurred costs and fees referred to in paragraph 12, which costs and fees shall be established on an annual basis in accordance with orders to be issued by the OEB from time to time. **[NTD: Consider if there is another mechanism available for Financing Entity to recover its costs without going to the OEB, perhaps subject to reporting requirements to the OEB and the ability for the OEB to review those reports]**

    a) Each Financing Entity shall apply to the OEB annually to dispose of the recorded balance

    b) The IESO shall make payments to the Financing Entity in accordance with such order of the OEB then in effect

    c) Each such order shall permit the Financing Entity to recover its approved amount over a period of 12 months

    d) The IESO shall collect the amounts specified in such orders of the OEB pursuant to s. 25.33 of the *Electricity Act* (i.e. through the global adjustment)

    e) [Until the administrative costs and fees are recovered as described above, OPG shall provide each Financing Entity with the funding required to carry on its operations (for greater certainty, excluding financing costs).] [NTD: See Note at paragraph 5(a).]