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The Ontario Fair Hydro Plan and its novel financing structure

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Authors: Rocco Sebastiano, Elliot A. Smith, Michael Innes, Katherine Royer

In response to political pressure due to rising electricity rates, the Ontario provincial government (the Province) announced earlier this year that it would be lowering electricity bills for residential consumers, small businesses and farms as part of a significant restructuring of how the costs of operating the electricity system are treated. Electricity rates have been rising in Ontario due in large part to the cost of fixed-price contracts entered into with clean energy generators over the last decade. These fixed-price contracts have increased the cost of electricity in Ontario as compared to other jurisdictions.

What does the Fair Hydro Plan do?

The Province's plan, known as the "Fair Hydro Plan," contemplates an immediate 25% reduction in electricity rates for eligible consumers. At the same time, it keeps the amount payable to generators of electricity (through the clean energy contracts and otherwise) unchanged.

The Fair Hydro Plan enables the Independent Electricity System Operator (IESO) to spread out the cost of these reductions over a number of years and to hold increases in electricity rates to the rate of inflation for a four-year period, beginning as of July 1, 2017. The costs to finance the reduction will be recovered from ratepayers in future years through additional charges on their electricity bills.

As part of the Fair Hydro Plan, the Province has directed the Ontario Energy Board (OEB) to approve the rate changes required to achieve the desired rate reductions and recoveries and has appointed Ontario Power Generation (OPG) as the manager of the Fair Hydro Plan.

How is the Fair Hydro Plan financed?

Instead of borrowing the required amounts to fund the reductions through the Ontario Financing Authority (OFA) or otherwise, the Province has adopted a funding structure that provides for the creation of a "regulatory asset" by the IESO, as legislated in the *Ontario Fair Hydro Plan Act, 2017*.

The "regulatory asset" represents the difference between what electricity generators are owed pursuant to their fixed-price contracts with the IESO and the reduced amounts collected from electricity ratepayers as a result of the reduction in electricity rates. In other words, the "regulatory asset" represents the shortfall created by the rate cut. The regulatory asset represents a current and irrevocable property right to impose, invoice, collect, receive and recover the amount of the shortfall by means of future charges imposed on eligible consumers.

The Fair Hydro Plan is unique in how it implements an immediate reduction in electricity rates for eligible consumers, by providing for the creation of a regulatory asset that represents the right of the IESO to collect revenue from future ratepayers to spread out the cost of these reductions over a number of years.

The IESO sells this regulatory asset to a special purpose trust created by OPG. The IESO uses the funds obtained from the trust pursuant to the sale of the regulatory asset to pay the electricity generators the full amounts they are owed. Effectively, the Fair Hydro Plan is a statutory-based securitization that generates the current cash needed to pay the generators today on the strength of a regulatory asset that permits recovery of the amounts in future charges paid by future electricity ratepayers. To facilitate this, the trust borrows money from capital market participants to purchase the regulatory asset. The trust incurs interest and other expenses on its borrowings. In addition, it pays fees to OPG as manager of the trust. These costs and fees are added to the IESO's shortfall amount and therefore increase the amount of the regulatory asset that the trust buys from the IESO.

In the future, the IESO will collect the money from ratepayers to repay the principal borrowed, plus interest and expenses. However, the exact amounts will remain uncertain until they are repaid.

Statute-based securitization has been used as a financing tool for power infrastructure assets across North America for a number of decades. This type of structure is most typically used as a solution to the problem of "stranded cost" recovery, which typically arises in electricity markets as they move to deregulation where future prices will be insufficient to recover sunk costs of legacy utilities. However, in such situations, the deficit is typically already known or is estimable at the outset. Therefore, a set deferral account and repayment schedule can be established in structuring the borrowing associated with such cost recovery.

What makes the Fair Hydro Plan unique and, to our knowledge, unprecedented, is the creation of an asset that represents the right of the IESO to collect revenue from future ratepayers' use of future electricity to make up for the present shortfall. This makes the precise scope of the cost deferrals unknown.

Critics of the Fair Hydro Plan have argued that it sets a dangerous precedent and unduly burdens future generations. However, nearly every Canadian province has, like Ontario, adopted clean energy plans that provide for some degree of subsidized provincial power purchase arrangements. It remains to be seen whether other Canadian provinces will look to Ontario's Fair Hydro Plan in developing financing strategies for the costs of investment in clean energy assets.

Osler has acted for the investment dealers, who will facilitate the financing transactions of the trust, in the design and implementation of the financing components of the Fair Hydro Plan.