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IESO Releases Contract Review Directive Report

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Last fall Ontario's Ministry of Energy, Northern Development and Mines directed the Independent Electricity System Operator (IESO) to retain an independent third party to undertake a targeted review of existing generation contracts in the province (see our November 8, 2019 bulletin). The stated objective of this review was to "identify opportunities to lower electricity costs within such generation contracts." The directive required that the IESO deliver the report, together with its assessment of the report's findings, by February 28, 2020.

The third-party report and the IESO's assessment of it were released last week and are available on the IESO website. Although the directive stated that the review was to focus on large gas, wind and solar contracts that expire within the next 10 years, the IESO notes in its assessment that such contracts account for only "approximately $1 [billion], or 5% of total annual Ontario electricity system costs." Accordingly, the review focused on all larger contracts, except for the Bruce Power Refurbishment Agreement, which the IESO notes "represents approximately $7 [billion], or 32% of total annual costs of the Ontario electricity system."

Not surprisingly, the report did not identify any potential savings that could be achieved under the terms of the existing contracts. As noted in our earlier bulletin, the government announced the cancellation of 758 renewable energy contracts in June 2018. The cancelled contracts all contained provisions allowing their termination (subject to the payment of prescribed termination costs) prior to the achievement of certain milestones. However, absent default, termination rights generally do not apply once a project achieves the specified milestones. Most, if not all, of the generation contracts subject to the review have achieved all applicable milestones and therefore, absent default, no contractual rights to terminate exist under these contracts. As the IESO itself notes in its assessment of the report "the IESO's generation contracts do not provide the IESO with termination for convenience rights once the facility has achieved commercial operation." The IESO also notes that the likelihood of existing contracts being terminated for default after achieving commercial operation is low given that "the contracted generator's obligations during the operating term are generally readily achievable by any prudent generator."

The report considers various opportunities for achieving cost savings under existing contracts, classifying such opportunities as "primary," "secondary" or "not material." The primary opportunities identified are "contract buyout" (whereby the IESO pays the supplier a lump sum in exchange for the supplier agreeing to terminate its contract); "contract buydown" (whereby the IESO pays the supplier a lump sum in exchange for the supplier agreeing to accept a lower price under its contract); and "blend and extend" (whereby the IESO and supplier agree to extend the term of the contract at a lower price). The secondary opportunities are contract-specific amendments and the use of renewable energy credits; however, the report concludes that contract-specific opportunities are not expected to result in significant costs savings and opportunities for costs savings through renewable energy credits are limited. Accordingly, these are not explored in any detail.

The report explores in considerable detail the aforementioned primary opportunities. While it concludes that there are potential costs savings that could be achieved for each opportunity, it also notes that there are a number of risks (i.e., reliability, planning and financial) and uncertainties surrounding each.

In its assessment of the report, the IESO notes that any saving resulting from the buydown or buyout option are predicated on the IESO borrowing significant amounts to fund the requisite payments (which costs are borne by the ratepayer) at a lower financing cost than that of the applicable supplier. However, as many of the existing projects are financed with long-term non-recourse debt, lender consent would be required and, as the IESO correctly points out, "Breakage of existing loan agreements would likely come with considerable costs."

The IESO assessment also notes that the “blend and extend” option raises not just the issue of lender consent and possible breakage costs, but also the likelihood that, although ratepayers would see lower costs in the short term, they would end up paying more over the life of the (extended) contract. This is because the discount rates used by the supplier are higher than those applied by the IESO, meaning that the supplier will place greater value on the lowered contract price during the remaining term and less so on the additional future revenue during the extended term (i.e., the supplier will demand a higher lump sum payment in consideration for the forgone revenue). The IESO therefore concludes that “blend and extend” is likely only a viable option for contracts that are approaching the end of their terms, at which point the supplier may place a greater value on the certainty of future revenue.

It remains to be seen what actions, if any, will be taken as a result of the report and assessment. As both the report and the IESO’s assessment note, the low-hanging fruit (i.e., termination of the 758 contracts) has already been realized and there are limited remaining opportunities for cost savings within the existing generation contracts. Although the “buydown” option emerges as the one with the greatest potential for savings, there are numerous implementation challenges. Furthermore, as the IESO notes in its assessment, it has been “actively pursuing and implementing opportunities to find efficiencies and cost savings within contracts, including contracts for facilities that are under development and those that are in commercial operation.” The IESO assessment also points out that the IESO’s Market Renewal Program is expected to make Ontario’s electricity market more efficient and could result in significant savings.

What is clear, however, is that the implementation of any meaningful cost-saving measures will require mutual cooperation with generators as opposed to unilateral action by the IESO. Whether or not a deal can be struck between the IESO and a particular generator will depend on the underlying facts at each facility, meaning that a project-by-project analysis is required as opposed to a “one size fits all” approach.

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