Summary Note
Office of the Auditor General of Ontario
The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money

ISSUE

The Office of the Auditor General of Ontario (OAG) shared a confidential draft of its special report on the Ontario Fair Hydro Plan for comment. The following provides a summary of the report's main arguments and recommendations.

SUMMARY

- A key assertion of the report is that the government passed legislation to make its own accounting rules to obfuscate the impact of the financial decisions, which it argues will result in unreliable financial statements.

- The report claims that after reviewing all information available, including emails from the Ministry of Energy, Treasury Board Secretariat, and the Ontario Financing Authority, it became clear that the government's intention in creating the accounting and financing design of the OFHP was to avoid an effect on the fiscal plan; specifically to avoid showing a deficit.

- The report makes the following arguments:
    - The planned accounting is incorrect and the financing structure will resulting in up to $4 billion in unnecessary costs.
    - While Ontarians will see a savings, power generators will still be owed the full cost of the electricity they generate, and the government will need to borrow to cover the shortfall.
    - The effects of this additional debt required to fund generators needs to be accounted for as part of the annual deficit and net debt of the Province. However, the government did not properly account for this in the 2017/18 Budget and is not planning on accounting for it property in future.
    - The government is essentially "making up its own accounting rules".
    - By 2028, ratepayers' electricity bills will have risen back up (minus the ongoing 8% reduction) and increase further to payback the debt incurred to finance the additional 17% rate reduction.

Accounting and Financing

- The report argues that the Fair Hydro Act creates a "needlessly complex" accounting and financing structure designed to avoid showing a deficit or increased debt in the government's financial statements. It specifically asserts that:

<u>*Financing*</u>

- The government's financing structure could result in Ontarian's paying up to $4 billion more than necessary.

- The government should use the same – "correct" - accounting treatment for the OFHP as was used for the stranded debt in 1999/2000.

- Several design options were considered, but were rejected due to the associated impact on the Province's deficit and/or debt.

- After 2027, the only remaining reduction to electricity bills will be the 8% equal to the provincial portion of HST. After 2028, ratepayers will be paying more than the actual cost of electricity in order to pay back borrowing.
    - Total borrowing is estimated at $39.4 billion. This includes $18.4 billion borrowed to finance the rate reduction, and $21 billion in accumulated interest.

<u>Accounting</u>

- The accounting treatment proposed in the Fair Hydro Act violates government accounting and is not in line with Canadian Public Sector Accounting Standards.

- The government knew that the risk of a qualified audit opinion was high when developing the OFHP, but chose to accept the risk in order to avoid showing a deficit/increased debt.

- The 2017/18 Budget does not, but should, include the full fiscal impact of the 25% reduction.
    - While it included the initial 8%, it does not reflect the $2.5 billion per year, on average, to fund the additional 17% reduction.

- If the government proceeds with the financing and accounting structure in the Fair Hydro Act, the Auditor General may issue an unprecedented '*adverse – does not present fairly'* opinion in next year's consolidated financial statements.
    - This could result in a loss of public trust and confidence.

RECOMMENDATIONS

- The report includes two recommendations to which the government was asked to respond by way of a 200-word response.

- On October 4th, the government provided a 2-page response reflecting the complexity of the issue. Please refer to Appendix A for the full response.

- The recommendations outlined in the draft report were:

    1. Record the true financial impact of the Fair Hydro Plan's electricity rate reduction on the Province's budgets and consolidated financial statements; and

    2. Use a financing structure to fund the rate reduction that is least costly for Ontarians.

APPENDIX A –

GOVERNMENT RESPONSE TO OAG REPORT ON THE FAIR HYDRO PLAN

The government of Ontario does not agree with the assertions and conclusions expressed in the report by the Office of the Auditor General (OAG) on *Ontario's Fair Hydro Plan (OFHP).*

OFHP is delivering the single-largest reduction in electricity rates in the province's history. In developing OFHP, 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. 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.

The government has been making important investments in a cleaner and more reliable energy system, but these investments have led to higher electricity bills. 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.

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. The majority of the province's electricity generators operate under 20-year contracts. Despite the report's assertion that it is "not at all" certain if these generating assets will be operating beyond their contract lives, third-party experts have confirmed that many of these generators will be able to continue to operate. 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.

The Global Adjustment (GA) pays for the bulk of the recent investments in the electricity system. Refinancing the GA provides significant and immediate rate relief by matching the cost of electricity investments with the expected useful life of the generation that has been built. Despite the report's assertion that the government's intention was to avoid recording a deficit in the fiscal plan, the decisions made to implement GA refinancing most effectively achieves the goals of the refinancing program and ensures that the deferred costs are borne by the rate-base, as the beneficiaries of the electricity system, and not the tax-base. The accounting for this transaction will reflect the substance of this transaction.

With respect to the Province's financial statements, they 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. As PSAS is set by an independent standard setting body in Canada focused specifically on the public sector, and because PSAS is used by all senior governments in Canada, presenting its financial statements in accordance with PSAS results in transparent financial reporting for the Province of Ontario.

The government of Ontario also disagrees with two fundamental accounting assertions in the report related to *legislated accounting* and *rate-regulated accounting*:

- Legislated Accounting – The *Ontario Fair Hydro Plan Act, 2017* and its related regulations do not create accounting rules or legislate the accounting. This is a fundamental disagreement with the report. As previously noted, the Province will prepare its consolidated financial statements in accordance with PSAS.

- Rate-Regulated Accounting – In commenting on the use of rate-regulated accounting and the role of the Ontario Energy Board (OEB), the report makes reference to a requirement under U.S. accounting standards in connection with the use of rate-regulated accounting that "there must be an independent regulator". This reference is misleading as it does not provide the criteria in its entirety, which is as follows:

  The entity's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator ***or by its own governing board empowered by statute or contract to establish rates that bind customers*** *[ASC 980-10-15-2].*

The U.S. accounting standard was developed specifically not to preclude the application of rate-regulated accounting by government utilities where the rate regulator would not necessarily be viewed as independent [FAS 71, par. 64]. In addition, the position that rate-regulated accounting is precluded because the OEB is not considered independent of the government of Ontario is contradictory to accepting the use of rate-regulated accounting by Ontario Power Generation (OPG) and Hydro One, both regulated by the OEB and whose results, using rate-regulated accounting, are and have been included in the consolidated financial statements of the Province.

The OFHP is comprised of a series of policy decisions, some of which will be borne by taxpayers where appropriate, such as sales tax relief and shifting social programs to the tax base, and some will be borne by ratepayers, such as spreading the investment costs and benefits across ratepayers more fairly. The accounting will reflect the economic substance of the transactions in accordance with PSAS and will differentiate those costs of OFHP borne by taxpayers vs. those borne by ratepayers. The report appears to suggest that all costs of OFHP should be reflected as if they will be borne by taxpayers, which is inaccurate.

OPG is beginning the process of raising funds to finance the deferred costs, and while total borrowing costs will not be known until the program is complete, accumulated interest is projected to be considerably less than the estimates in the report of the Financial Accountability Office (FAO), cited by the report. Total borrowing estimates over the thirty year life of the program have been revised down substantially by the government since the FAO released its report in May 2017 and borrowing costs are now forecast to be substantially lower than original estimates. Current government estimates forecast that the peak debt over the thirty year life of OFHP will be below $20 billion. The preliminary estimate from March 2017 was about $28 billion.

Based on the comments above, and given that implementation of OFHP is ongoing with significant accounting and financing decisions still being finalized, the government believes that this report does not reflect the technical substance of the OFHP, some of which has yet to be implemented.