TBS

Assessment Note

Office of the Provincial Controller Division
Financial Reporting and Fiscal Support Branch

Adopting the Accounting Recommendations of the Auditor General – Fair Hydro Plan

Issue:

Describe the options for adopting accounting treatment for the Fair Hydro Plan as recommended by the Auditor General.

Overview:

In the 2016-17 opinion on the consolidated financial statements of the province, the Auditor General raised two issues that relate to the Independent Electricity System Operator - (IESO) – the recording of market accounts and the use of rate regulated accounting, disagreeing with both. Subsequently in October 2017, the Auditor General released a Special Report on the Fair Hydro Plan. In that report she commented on the accounting for the Global Adjustment Refinancing of the Fair Hydro Plan and noted the following in Section 4.4:

> As stated in Section 4.1, the government of Ontario has historically chosen to use Canadian PSAS as the basis of accounting for its preparation of the Province's consolidated financial statements. So by legislating an accounting design contrary to Canadian PSAS, the government is also going against its own accounting policies. As described in Section 1.3.1, recording the Fair Hydro Act's rate reduction in accordance with Canadian PSAS entails the following:
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> - All related debt, including that of OPG and OPG Trust, would become debt on the Province's financial statements.
> - All interest expense would become an expense of the Province.
> - The annual shortfall between the amount paid to generators and the amount collected from local distribution companies would be recorded as an expense of the Province.
> - The amount collected in the future through the clean energy adjustment to pay down the accumulated principal and interest and other expenses of $39.4 billion would be recorded in the future as revenue of the Province.

While the 2017 financial statements of the IESO and OPG have been released, reflecting the impact of the Fair Hydro Plan on their organizations for 2017, the Province has not released its consolidated financial statements.

The Province has released its 2018 Budget and 2018 Pre-Election Report, both of which focus primarily on the projected surplus/(deficit) of the province in future years. Therefore the difference between the Province's accounting for the Global Adjustment Refinancing and that of the Auditor General is based on the Province's accounting as determined by OPCD and the special report issued by the Auditor General.

In summary the differences in accounting, noted in both the audit opinion for 2016-17 and the Special Report on the Fair Hydro Plan are:

Issue	Province's Accounting Determination	Auditor General Accounting Determination
Recording of market accounts on the statement of financial position	Record the market accounts	Do not record the market accounts
Using rate-regulated accounting for entities applying PSAS	Use of rate-regulated accounting is acceptable	Use of rate-regulated accounting is not acceptable
Recording of debt used to finance the Global Adjustment Refinancing	Debt issued by the province is recorded in Debt on the province's statement of financial position; Debt issued by OPG or its subsidiaries is recorded by OPG and recorded in the Investment in Government Business Enterprises on the statement of financial position	All debt should be recorded as if it was issued directly by the Province and should be recorded in Debt on the province's statement of financial position.
Recording of interest incurred on debt used to finance the Global Adjustment Refinancing	Interest on debt issued directly by the province is expensed as incurred. Interest recoverable from future ratepayers and that meets the criteria for recording rate-regulated asset is recorded as such.	All interest is expensed as incurred.
Recording of annual shortfall between the amount IESO collects from the ratepayers and the amount paid to the generators	The shortfall that is recoverable from future ratepayers and that meets the criteria for recording as a rate-regulated asset is recorded as such	The shortfall should be expensed as incurred.
Recording of excess collected from ratepayers in the future to repay the cumulative shortfall.	The repayment is recorded as revenue, with an offsetting expense recognized as the rate-regulated asset is drawn down, resulting in no impact to the annual surplus/deficit.	The repayment is recorded as revenue as earned in future years.

Market Accounts - Independent Electricity System Operator - (IESO)

As a counterparty to the contracts between power generators and local power distributors, there are settlement balances arising at the end of the fiscal year. In 2017, the IESO changed their accounting to record these balances (which net to NIL on the balance sheet) in their financial statements.

Fair Hydro Plan

The Fair Hydro Plan was passed in May 2017. As part of the Fair Hydro Plan's policy objectives to reduce consumer hydro bills by 25%, a portion (approximately two-thirds) of this reduction was achieved through redistributing the timing of recovery from ratepayers for the investments in green energy through contracts with power generator currently in effect. This deferral creates a shortfall which must be made up through borrowing (to fulfill the contractual obligations to power generators). The future recovery from ratepayers will occur through the introduction of a dedicated charge (the Clean Energy Adjustment (CEA)) to consumers' electricity bills starting in 2022.

In the regulated sectors, companies in Canada are currently permitted under a transitional provision in private-sector accounting standards (International Financial Reporting Standards or US GAAP) to defer recognition of expenses where recovery is expected from customers. This is referred to as "rate-regulated accounting". In Ontario, both Ontario Power Generation and Hydro One use the approach. Public Sector Accounting Standards are silent on the use of rate-regulated accounting. In such cases, professional judgment is applied to assess the nature of the transaction and the most appropriate representation of the circumstances using sources of accounting guidance issued by other accounting bodies. In evaluating other sources, the principles adopted must be consistent with the concepts of Public Sector Accounting Standards (e.g. definition of an asset). In this case, the application of rate-regulated accounting by the Independent Electricity System Operator was determined appropriate as this entity is industry regulated (by the Ontario Energy Board) the application of rate-regulated accounting was determined consistent with the core concepts of Public Sector Accounting Standards.

Considerations:

Changes in the accounting currently used by the Province will require legislative, regulatory or policy changes.

For the accounting for the <u>market accounts</u>,

- The IESO is currently classified as an Other Government Organization under PSAS. The government could review this classification and/or make legislative changes which would alter its classification to that of a Government Business Entity or a Trust Under Administration. The results of this change would be to consolidate the IESO on a one-line basis (like Hydro One and Ontario Power Generation) as a GBE or not consolidate it (but solely disclose in the notes to the financial statements) as a Trust Under Administration.

Pros	Cons
• The market accounts would not be recorded on the statement of financial position of the province	• Supporting rationale for the change would be subject to scrutiny
•	• Management and external auditors of IESO may not agree with any change to its classification.

- As a practice, we rely on the opinion of the external auditors of the consolidated entities to confirm the balances we are consolidating. In this case, the OPCD could establish a Provincial accounting policy with respect to market accounts and adjust the statements to remove the market accounts from the consolidated balances and include a note disclosure to the consolidated financial statements

Pros

- PSAS requires adjustments for differences in accounting policies for consolidated entities; currently done in other circumstances (e.g. hospital capital projects under AFP model) to ensure consistency

Cons

- Creates discrepancies between the audited financial statement presented in Volume 2 and the consolidated financial statements

For the <u>Fair Hydro Plan</u> accounting, there are several options:

- The government can pass a regulation to direct an accounting interpretation of PSAS to be used by the Independent Electricity System Operator (IESO) which prohibits the use of rate-regulated accounting. This would result in the IESO reporting the expense related to the shortfall which would be consolidated to the Province's expense.

Pros

- Not a precedent; have issued regulations to clarify interpretation of PSAS in the past (e.g. school board accounting for capital contributions)

Cons

- AG is not supportive of the use of regulation to define accounting which, in her opinion, deviates from PSAS

- The government can amend the *Ontario Fair Hydro Plan Act* to remove the recovery from ratepayers through the Clean Energy Adjustment; this would remove the necessary circumstances related to recovery from ratepayers needed to recognize a rate-regulated asset under US GAAP and thus require it to be expensed by the IESO.

Pros

- Clearly establishes the tax base as the source for repayment; no longer a rate-regulated asset under accounting guidance

Cons

- Deviates from established practice for energy investments being recovered from the ratepayer
- Changing policy direction to achieve a change in accounting treatment

- The government can amend the terms of the trust agreements with the Financial Services Manager of the Fair Hydro Plan Trust (currently OPG) to bring the Fair Hydro Plan Trust under the direct control of the Province requiring it to be consolidated as a government organization. Intangible assets are not permitted under PSAS so any such balances reported by the Fair Hydro Plan Trust would be adjusted to expense upon consolidation under PSAS.

Pros	Cons
• Brings decision-making back to MOF on terms of debt issuance (currently with OPG)	• Challenges the need for the FHP Trust; decision on whether to wind-up or not
• Provides option for government to borrow directly for the full financing and lower interest cost	• Changing policy decision to achieve a change in accounting (e.g. borrowing for electricity sector historically priced at sector interest rates)

Delivery/Timelines:

Legislative and/or policy changes invoked prior to the release of the 2018 Public Accounts and specifically applicable would be reflected in the consolidated financial statements. The Public Accounts is required to be released within 180 days after the fiscal year end (March 31).

Other Jurisdictions:

For both of these issues, factual circumstances are unique to Ontario and jurisdictional comparison may not be fully reflective of options available to the government.

Other Considerations:

The government may wish to create an Audit Committee composed of senior officials and the Auditor General to discuss emerging accounting issues and their impact on the Public Accounts. The purpose of this non-binding committee would be to bring forward items identified through the Public Accounts (and throughout the year) for a broader discussion of objectives and clarification in the government's reporting.

Commented [DM(1]: Need wording from AC deck?