Briefing Note

Office of the Treasury Board
Office of the Provincial Controller Division
Program Expenditure Management Division

Debt Financing the Global Adjustment: Preliminary Accounting and Fiscal Analysis

Issue:

What would the fiscal impact related to the Ministry of Energy's proposed electricity rate mitigation option in which the billing impact of the Global Adjustment (GA) on ratepayers would be reprofiled to be lower in the immediate term and spread out over a longer timeframe. What would the fiscal impact be for the incremental cost of the initiative associated with debt financing which would be borne through future rates?

Current Status:

The Ministry of Energy has requested comments from the Ministry of Finance and Treasury Board Secretariat.

Background:

The Ministry is implementing a series of electricity price mitigation initiatives, such as the Ontario Rebate for Electricity Consumers (OREC provides a rebate of 8% of electricity bills) that launched January 1, 2017. OREC is currently funded from taxpayers. The Ministry is also developing further electricity rate mitigation initiatives that utilize cap and trade proceeds, including rate relief for industrial and commercial consumers. In addition, MOECC's Climate Change Agency is expected to develop further programs that could provide rate relief.

Global Adjustment (GA) is comprised of several elements. A key part of the GA charge is to electricity consumers to make up the gap between the market price of electricity and the higher, non-market prices that most electricity producers, both public and private producers, receive through contract prices (referred to as the RPP). For residential customers, GA is embedded within time of use rates as a cost per kilowatt hour. For major manufacturers and large businesses, the fee appears separately on electricity bills. Since payments made to producers by the IESO are passed through to the LDCs through billing of ratepayers, the GA is fiscally neutral to the Province (excluding the amount of the payments that are received by OPG and therefore, consolidated). For financial reporting purposes, the IESO does not report the costs recoverable through the GA nor the amounts borrowed to fund producer payments on its books. This accounting has been accepted by the entity's external auditors on the grounds that the IESO acts as an agent in the settlements process. The amounts are however reported on the 'market books' of the IESO which are subject to independent external review every two years. Borrowing to fund the timing gap between funding of producers and reimbursement through billings is provided for by the OFA which previously provided such funding to the Ontario Power Authority which paid the producers prior to the merger of the OPA and IESO on January 1, 2015. While the OPA used to report the related debt (liability to OFA) and receivable (from

IESO) on its financial statements, on a post-merger basis neither of these amounts are reported on the IESO's audited financial statements. The only debt reported on the IESO's balance sheet relates to operating costs. As such, there does not appear to be a corresponding payable on the IESO's books to offset the OFA's receivable upon consolidation., Energy's proposal includes scenarios that set the 2017 amount of GA paid by ratepayers at a value lower than the true cost of GA and increasing that amount year-over-year at inflation (assumed to be 2%) until the debt has been paid off. Debt would be used to finance a portion of IESO's costs resulting from the timing gaps between producer/program expenses and proceeds collected from energy consumers through the GA. In effect, debt would be leveraged to extend the period over which the GA costs would be recovered in anticipation of longer estimated service lives and lower future costs. Interjurisdicational precedents (MB, AB) demonstrate longer service life contracts negotiated with non-utility generators.

Commented [np1]: OPCD following up on change in accounting post-merger. IESO to provide details of post-merger accounting policies.

At this time, it is not clear which entity (the Province (OFA), IESO or some other non-government entity) would issue the debt, and therefore whether IESO would receive proceeds, and if so, how that would be recorded. Depending on decisions regarding which party provides the debt, how amounts recoverable from ratepayers are accounted for and the IESO's accounting policies, the proposal could have impacts on the Province's consolidated debt position, Net Debt and Interest On Debt.

Under an assumption that OFA would borrow in the market and lend the money to IESO to bridge the gap between the amounts paid to the producers and the amounts collected from ratepayers as it related to the GA, it appears that under its current accounting policy, the IESO would not report the payable on its books, and that the related receivable (recoverable through future rates) may not be reported on the IESO's financial statements either. Without the benefit of an offsetting payable to offset the OFA's receivable from the IESO (assuming an asset test could be met), the Province's consolidated financial statements would continue to be impacted. It is assumed that the OFA, as borrowing agent on behalf of the IESO, would be able to report a receivable from the IESO for the principle amount of the loan and interest, in addition to reporting the incremental payable (debt) incurred to finance the rate mitigation/smoothing.

Commented [np2]: See comment above.

Alternatively, if the IESO were to borrow from a 3rd party, non-controlled entity, the neither the incremental debt nor receivable from the IESO would appear on the government's financial statements. Assuming no change in the IESO's accounting treatment for GA costs, the cumulative costs and anticipated future recoveries would also not appear on the IESO's audited financial statements, and therefore not be reflected on the government's consolidated financial statements. In order to be considered 'not controlled' and not consolidated on the Province's books, the province could not control the financial or operating policies of the entity. This option is currently under consideration as one option.

Commented [np3]: If assessed as controlled, accounting treatment would be worse than OFA as all of the entity's assets and liabilities, and operating results would be reflected on the government's books.

Commented [np4]: Suggests that it should likely be a large financial institution rather than a trust established solely for this purpose.

A third alternative under consideration is whether a receivable from the LDCs might be sufficient to support a receivable being reported by the Province to offset incremental debt. This alternative is challenging for a number of reasons including: limited debt capacity at the LDC level, potential breach of debt covenants at the LDC level, and the fact that 20% of GA billings are to direct industrial customers.

For an informed fiscal analysis, the assumptions and quantitative analysis in the proposal would benefit from further review and analysis, both to assess the potential impact on consumer rates and the appropriate accounting treatment on the Province's consolidated financial statements. The Ministry of Energy has outlined a number of anticipated impacts on ratepayers. It is unclear whether these could result in further pressure on the government to offset these. These include:

- Incurring debt to finance the GA, while lowering ratepayer costs in the short term, the proposal results in a more rapid rise in electricity prices in the future beyond the rate of increase currently expected.

- The GA financing proposal involves accruing large amounts of debt to reduce interim electricity rates. This debt would be highly sensitive to interest rates which could extend repayment timelines or put significant pressure on rates (see Scenario 3 for an example of such interest rate risk).
- GA and HOEP provide a natural hedge against each other. Smoothing only one component would lead to greater price volatility. For example, if HOEP is higher than expected (due to higher gas or carbon prices, for example), all-in rates will rise significantly as the natural decrease in GA would not occur given the prescribed GA rate.
- Conversely, if GA is higher than forecast (i.e., because of lower HOEP or additional out-of-market costs), the debt would increase to a higher amount, requiring additional debt service payments and/or a longer recovery period.
- Should Ontario demand be lower than forecasted, the cost of paying off the debt will be shared by a smaller pool of consumption, further increasing future costs for individual ratepayers.

Accounting Treatment and Risks

The following analysis is based on the deck provided (included in Appendix A) as well as recent discussions with the Ministry of Energy, OFA and the IESO regarding the accounting for GA related costs on the IESO's books.

The focus on the accounting treatment is based on the impact to the consolidated financial statements of the Province. IESO is a consolidated entity of the Province and follows Public Sector Accounting Standards. As such, IESO does not follow rate-regulated accounting (no such concept exists in PSAS). OPCD's current understanding is that the IESO does not report any liabilities or receivables related to GA related activities on its audited financial statements. As an agent responsible for performing the settlement function, the IESO does not publicly disclose amounts collected under the GA, but does post the results of an independent review of its internal controls which is undertaken every two years. Under the assumption that financing costs would also be recoverable through the GA mechanism, and that the same accounting treatment would apply as for other GA costs, it is likely that the incremental debt incurred by the IESO to finance the reprofiled GA would not be reported on the Province's financial statements. The reporting basis used for the IESO's market reports is not clear; however, it is possible that the incremental financing costs would be reported as a recoverable on the market books if legislation were enacted to ensure it is a recoverable cost under the GA. Note that any recoverable costs would also likely be excluded from the IESO's audited financial statements if the status quo accounting treatment is applied.

Implications of OFA borrowing and anticipated IESO accounting treatment: Under the scenario where the OFA borrows the money on behalf of the IESO, the Province's books would reflect the additional debt incurred. It is uncertain at this time whether the receivable would be reportable as it would not be reported on the IESO's audited financial statements. If the AG is able to accept a payable reflected in the IESO's market accounts as evidence of an asset for amounts not yet billed to the ultimate consumers, then the Province's net debt position will not increase. IESO and KPMG should be requested by MOE to provide additional context on historical off-balance sheet accounting treatment.

Commented [np5]: Could the receivable be commoditized? Might that be cheaper than the incremental cost of using a 3rd party borrower?

If the difference in amounts which are currently eligible for recovery under the GA and the increased costs associated with the proposal do not meet the asset test (i.e. demonstrated as recoverable), then they risk being reported as an expense to the Province in the period in which the incremental costs are incurred.

In summary, there is significant accounting and fiscal risk associated with the proposal if the government cannot demonstrate that a financial asset exists. The AG would need to be convinced that the amount recoverable from future consumers but not yet billed is an asset. Since PSAB does not recognize rate regulated assets and the OEB does not oversee the GA billing process, this may be a challenge under PSAB standards. It is uncertain whether an asset could be created via legislation and reported on the Province's books.

Where a non-controlled trust is created and reports (assumed based on IFRS14) a regulatory asset, it is more likely that the Province can defend a receivable on its books for amounts loaned.

Although the OEB does not typically oversee the GA, the OEB does oversee recoverability of the RPP accounts. An assessment of recovery risk should also be undertaken to assess potential that the OEB may deem any amount of the proposed increase in costs over the longer term to be non-recoverable from future ratepayers.

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