Confidential **Drafted: August 21, 2017**

FAIR HYDRO PLAN ACCOUNTING (GLOBAL ADJUSTMENT REFINANCING)

ISSUE: What is the basis for the proposed accounting for the Global Adjustment Refinancing on the Province's books?

KEY MESSAGES:

- In order to meet the needs of users, including the legislature and the public, for accountability in government reporting and decision making, it is essential that public sector financial statements reflect the economic substance of the government's activities.

- In assessing the appropriate accounting treatment for the Global Adjustment refinancing component of the Fair Hydro Plan on the Province's authoritative guidance issued by the Public Sector Accounting Board, as well as the accounting assessments of the Independent Electricity System Operator (IESO) and Ontario Power Generation (OPG) management, including the accounting opinions of their external accounting advisors.

- Given the complexity of the GA Refinancing structure, the exercise of professional judgement is necessary to ensure that key financial reporting objectives of transparency and accountability are best served. It was also prudent to consider other currently available information, including current efforts underway by the International Accounting Standards Board related to rate regulated accounting.

- Under GA Refinancing, the Province will borrow funds to pay a portion of current electricity costs, thereby temporarily reducing the amount paid by eligible ratepayers. The deferred amounts, including interest and other costs, will be recoverable from ratepayers through future rates over an estimated 18-year period starting in approximately 2028.

- In simple terms, this is just a shift in the timing of recovery of the cost of clean energy investments from consumers. Although generators would continue to be paid over their twenty year contract periods, the amounts paid by the IESO to the generators would be recovered from ratepayers over a longer thirty year period.

- The FHP Act permits the IESO to transfer or sell its deferred recovery amount (its regulatory asset) to a financing entity to fund its cash shortfall, thus commoditizing the future cash flow stream.

Commented [OPCD1]: Similar LIPA. Insert comparative?

- To help administer the deferral of the Global Adjustment, OPG expects to establish a Trust that would be controlled and consolidated by OPG and would be reflected on the province's books through consolidation of OPG on the modified equity basis.

- At its discretion, OPG Trust would finance these purchases through a combination of provincial borrowing (flowed through OPG as an equity investment), amounts advanced from OPG and direct borrowing from capital markets.

Commented [OPCD2]: However, once the framework is established, if the Trust is not assessed as controlled by OPG, the accounting treatment and fiscal impact of the GA refinancing will be reassessed. Note somewhere?

- As a classified Other Government Organization, the IESO prepares its financial statements in accordance with CPA Canada's Public Sector Accounting Standards which is the same basis of reporting that the Province uses. The accounting used by the IESO for its rate regulated assets would therefore be consistently applied on consolidation of the entity on the province's books.

- Effective January 1, 2016, the IESO adopted on a retrospective basis a new accounting policy which is supported by the Office of the Provincial Controller.

- As a result of the change in accounting, in its December 31, 2016 audited financial statements, the IESO reflected its market-settlement activities, including the net recoverable amount from ratepayers which was reported as an asset.

- As I mentioned the Office of the Provincial Controller supports the IESO's change in accounting as better meeting users' needs for transparency and accountability. The entity also received a clean audit opinion from its external auditors under the new accounting treatment. As at March 31, 2017 the value of the net recoverable amount recorded on the IESO's books was $XM which will be reported on the Province's Public Accounts.

- In the future, under the Fair Hydro Plan, the GA Refinancing could result in significantly higher regulatory asset balances on the IESO's books until such time as the assets are sold.
- On the province's books which are prepared on PSAS, those recoverable amounts would be reported as financial assets on the province's balance sheet.
- While the recovery of the asset is dependent on future consumption of electricity by rate-payers, given the nature and extent of customer demand for the power generated and distributed in Ontario, both at this time and projected in the future, it is reasonable to conclude that it is probable there would be sufficient demand in the future to recover the balance of any regulatory assets on the IESO's books, or the value of any assets reported on OPG's books as purchased through the Trust.
- Accounting standards do not comprehensively cover all possible transaction scenarios, thus it is sometimes necessary to apply professional judgement in assessing the appropriate accounting treatment that best reflects the substance of a transaction.
- While PSAS does not specifically address the treatment of costs incurred that will be recovered through regulatory operations in future periods, the IESO would not be precluded from applying US GAAP guidance on rate regulated accounting where it can be demonstrated that the US GAAP guidance is consistent with the application of PSAS financial statement concepts.

- With regards to this requirement, both the IESO and OPCD have assessed the assets reported by the IESO as meeting the PSAS requirements for recognition of an asset under PSAS 1000. The IESO's position that the regulatory asset possesses the three essential characteristics of an asset reflects the following considerations related to the assets:

i. Embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows

ii. The public sector entity can control the economic resource and access to the future economic benefits

iii. The transaction or event giving rise to the public sector entity's control has already occurred

- In fact, since the assets recorded by the IESO meet the definition of an asset under PSAS, one could argue that the reference to US GAAP's rate regulated accounting is not even necessary for the IESO and the Province to recognize the balances for accounting purposes under PSAS.
- The Auditor General has suggested that PSAS requires that International Financial Reporting Standards be consulted prior to referring to US GAAP for guidance on accounting for the IESO's rate regulated assets. We don't agree with the AG's suggestion, also not that the IFRS standards do not conflict with the Province's current position.
- Comments from a May 2017 IASB Board meeting, "we also considered the interaction between the definitions of assets and liabilities and the characteristics of defined rate regulation (see paragraphs 5 and 6). We concluded that a combination of those characteristics suggested that the rights and obligations created by the rate-adjustment mechanism are assets and liabilities, as those terms are expected to be defined in the forthcoming revised Conceptual Framework for Financial Reporting."
- Although we do not believe that the IASB's project on rate regulated accounting is necessarily relevant to the IESO's accounting treatment for these assets, we feel that is important to point out that the IASB's recent activity suggests that it would be premature to assume that the IASB will conclude that regulatory deferral account balances will not meet the definitions of an asset or a liability.

- OPCD agrees that the appropriate classification of the IESOs GA refinancing assets would be as financial assets, consistent with the IESO's classification thereof. By recognizing the regulatory assets as financial assets, the FHP will have a neutral impact on both the Province's net debt and accumulated deficit and maintain the usefulness of the financial statements to the Legislature and the public.

- The Auditor General has not raised any concerns to date with the intended accounting for the OPG Trust on the Province's books.

- Purchases by the Trust of the rate regulated assets from the IESO will be reflected on OPG's books as intangible assets which will be reflect in the consolidation of OPG on the province's books.

- In assessing the appropriate accounting for the FHP on the Province's books, TBS worked closely with key ministries, the OEB, the IESO, OPG and their respective external advisors.

- The final accounting treatment for FHP related activities will be confirmed once all elements of the GA Refinancing framework are finalized, including provincial guarantees and financing arrangements.

- Once the details and commercial agreements of the FHP are finalized, the external auditors of the IESO and OPG are expected to provide independent accounting opinions on the accounting treatment on IESO and OPG's financial statements.

- The Office of the Provincial Controller will rely on those independent accounting opinions, and the audited financial statements of the IESO and OPG for the 2017-18 Public Accounts.

IF PRESSED: PRIOR AG RULING

- The OEFC stranded debt arose in 1999 as a result of the restructuring of the electricity sector under the Energy Competition Act, 1998, including the breakup of the former Ontario Hydro, introducing competition and creating a tax-payments-in-lieu of taxes level playing field for private and public sector owned electricity companies..

- The assets and balances to be reported on the Province's books under the FHP are not like the Stranded Debt which is not reflected on the Province's books. Rather the related debt that is borrowed by the Province and the Trust will be reflected on the Province's books, but will be offset by assets representing amounts amounts that will be recovered from ratepayers in the future.
- The assets to be reported on the Province's books have tangible value as evidenced by a recent DBRS press release which commented that: "Provided the debt continues to be fully supported by the electricity rate base, DBRS will treat it as self-supported and exclude it from the calculation of tax-supported debt."

IF PRESSED: AG ACCUSATION OF LEGISLATED ACCOUNTING

- The Auditor General has made several incorrect references to legislated accounting which I feel must be addressed to ensure clarity and transparency in terms of the government's accounting treatment for the Fair Hydro Plan.
- In particular, that Auditor General has referred to legislated accounting prescribed by the FHP Act that is designed to in some way manipulate the Province's financial reporting in its consolidated financial statements.
- It is a fact that the Province's financial statements are based on Public Sector Accounting Standards as issued by the Public Sector Accounting Board of CPA Canada. There is no legislated accounting that applies to the Province's consolidate financial statements.
- While the FHP Act does, under Section 24, require that the IESO set up a variance account to track the cash shortfall amount resulting from the deferred recovery amount, it is just another type of regulatory account, similar to those that OPG

reports and for which the OEB is responsible for approving rates.

- As far as the Province's financial reporting practices go, whether the deferred amounts reported in the IESO's variance account are assessed as assets for financial reporting purposes will be determined by the interpretation and application of Public Sector Accounting Standards, not by the legislation or regulations.
- We do not think that it is in the public's best interest to confuse the legislature of the public on the nature of the Province's financial reporting practices, or the integrity of the Province's financial reports.

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Appendix

Proposed Legislated Transaction Structure

Prepared by the Office of the Auditor General of Ontario