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Office of the Provincial Controller Division

Ontario Fair Hydro Plan – Accounting for Market Accounts and Rate-regulated balances under Public Sector Accounting Standards

Agenda

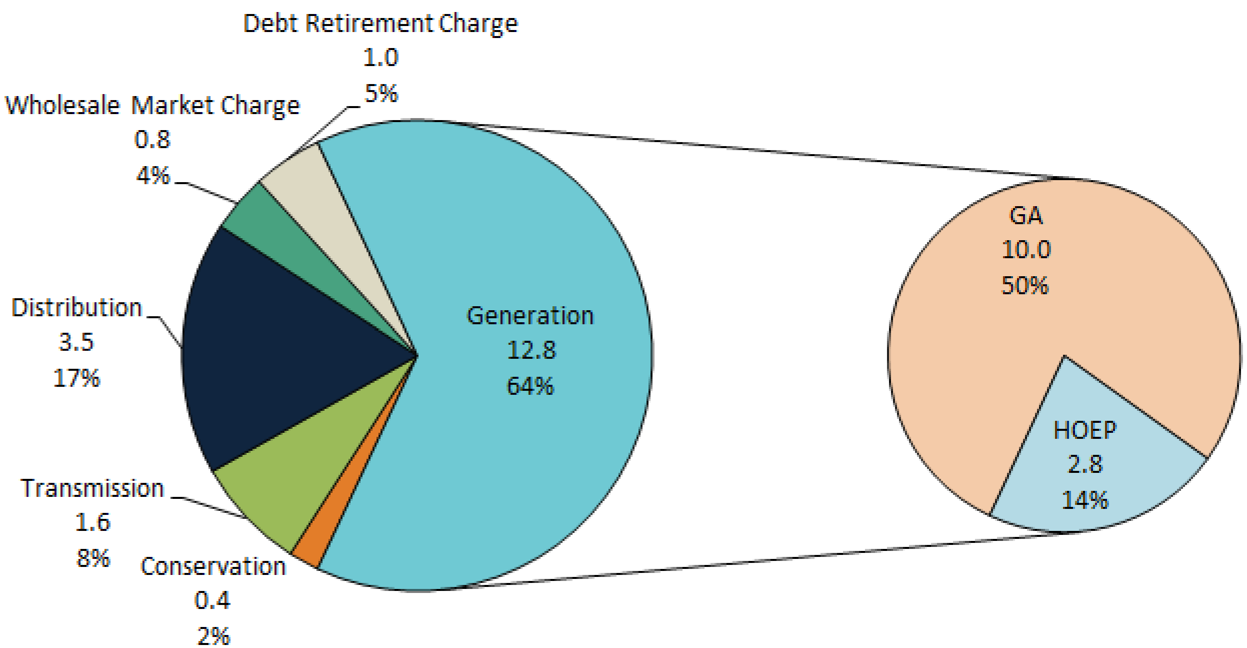
- Ontario's Electricity Market – Background and Context
- Ontario Fair Hydro Plan
- Use of Rate Regulated Accounting under PSAS
- Accounting for the Market Accounts of IESO

Ontario's Electricity Market -- Background

Ontario's Electricity Market

- In 2015, generation accounted for 64% of total electricity system costs. Total system costs in 2015 were $20 billion.

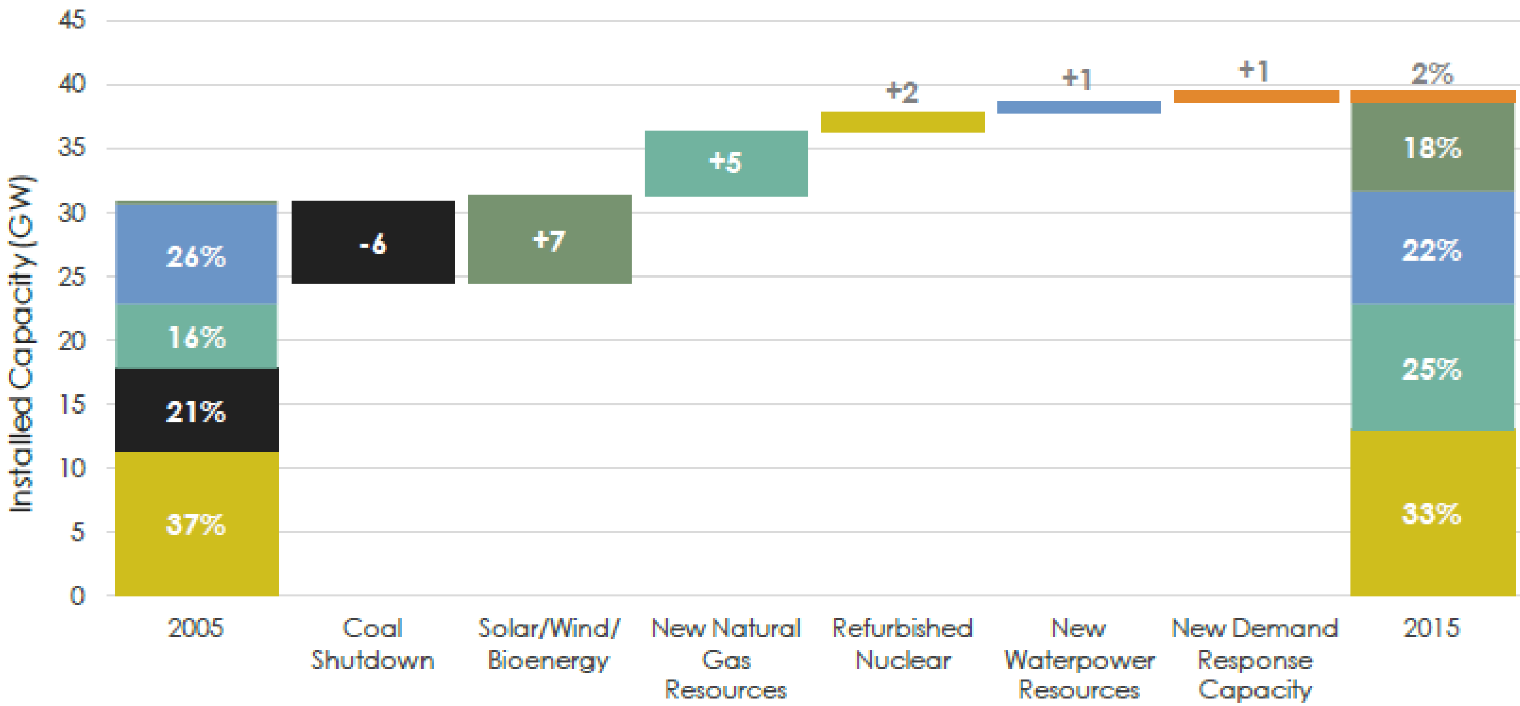
2015 Electricity System Cost
$ billion



Source: IESO

Significant Change in Supply Mix

- Between 2005 and 2015, government invested more than $50 billion in the electricity system, including $35 billion in electricity generation to restore reliability, replace coal and meet environmental objectives.
  - Electricity costs are increasing as necessary investments are made to decarbonize and modernize the province's electricity infrastructure.



Source: *IESO*

Electricity Prices Have Increased

- Since 2010, electricity prices have increased at a rate higher than the Consumer Price Index (CPI).

Typical Residential Electricity Bills
in $ per month, 750 kWh consumption

Source: *Ministry of Energy*

2017 Long-term Energy Plan

Recent Actions To Mitigate Electricity Rates

- Following the 2016 Throne Speech, several actions were announced to further reduce electricity costs.
  - As of January 1, 2017, Ontario is rebating an amount equal to the provincial portion of the HST to reduce eligible residential, small business and farm electricity bills by 8%.
  - Expanded support available to eligible rural ratepayers by updating Rural or Remote Rate Protection (RRRP) with additional relief, decreasing total electricity bills by an average of $45 each month when combined with the 8% rebate.
  - Expanding the Industrial Conservation Initiative (ICI) – up to one-third savings for participants.
  - Suspending the LRP II and the Energy from Waste Standard Offer Program (EFWSOP) – up to $3.8 billion in cost savings.
  - Limiting the Feed-In Tariff (FIT) 5 procurement target to 150 MW and suspending future FIT procurements – up to $129 million in cost savings.

Ontario's Electricity System

- Ontario's electricity system is a $20 billion annual sector that serves the needs of nearly 5 million homes, businesses, farms and industries.

- The Ontario Energy Board (OEB) is the independent regulator of Ontario's energy sector. It approves rates and prices that are reasonable to consumers and allow utilities and generators to invest in the system.

- The Independent Electricity System Operator (IESO) is a not-for-profit entity that manages the province's power system to ensure Ontarians receive power when and where they need it. It also manages contracts with non-regulated generators. In addition, the IESO plans and prepares for future electricity needs, and works with its partners to guide conservation-related efforts.

- Ontario Power Generation (OPG) is wholly-owned by the Province of Ontario and produces almost half of the electricity used in Ontario. OPG owns and operates: two nuclear stations, 66 hydroelectric stations, two biomass stations and one thermal station.

Role of the Independent Electricity System Operator

- The IESO is a corporation established pursuant to Part II of the Electricity Act, 1998, and administers $17 billion of the $20 billion annual electricity system, settling transactions between generators and consumers of electricity.

- One of IESO's roles is to settle the market accounts, which are the amounts due to the entities who provide electricity to the market (e.g. power generators) and due from those who consume electricity (e.g. local distribution companies on behalf of their consumers).

- The IESO is rate-regulated under the Electricity Act (1998) and the Ontario Energy Board Act (1998) by virtue of its right to recover the following costs from future ratepayers as determined by the Ontario Energy Board:
  - Revenue, expenditure requirement and fees
  - Smart meter expenses
  - PSAB transition items
  - Market settlements (Rate Protection Price (RPP), Ontario Electricity Support Program (OESP), Rural or Remote Rate Protection (RRRP))

IESO Changes in Accounting Policy

- In 2016, IESO made two changes in its accounting policies:
  - adopted rate-regulated accounting
  - Reflected the market accounts in the statement of financial position
  - for changed the accounting to include the market accounts (including the regulated asset/liability associated with the cash flow deficit/surplus from the RPP), recognizing the amounts to be settled as assets and liabilities in the Statement of Financial Position, equal in amount.

- The reporting for the market accounts better reflects the economic substance of IESO's operations and enhances the relevance, transparency and accountability of its financial reporting

- IESO management determined that rate-regulated accounting is appropriate and well understood in the North American electricity sector, and the recognition of regulatory assets brings IESO in line with 6 other independent system operators – AESO (Alberta), ISO New England, NYISO (New York), MISO (Midwest United States), PJM (Eastern United States) and ERCOT (Texas).

- The Ontario Power Authority, which merged with the IESO on January 1, 2015, presented in its unqualified, audited financial statements under PSAS, a segment of the market accounts for settlement with generators under contracts

Role of the Ontario Energy Board

- The OEB has been established by the Province to be Ontario's independent energy regulator; its mandate and authority come from the Ontario Energy Board Act, 1998, the Electricity Act, 1998, and a number of other provincial statutes.

- As noted previously, the rates charged by the IESO to electricity consumers are determined by the OEB, and therefore, it is considered the governing board of the IESO.

- While both the IESO and the OEB are controlled by the Province, this does not negate the role the OEB plays with respect the electricity market nor the determination of the IESO as a rate-regulated entity
  - Under US GAAP, the requirement is an independent, third-party regulator <u>or its own governing board empowered by statute</u> or contract.

Ontario's Fair Hydro Plan

- 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 Ontario Fair Hydro Plan Act ("OFHPA") provides Ontario ratepayers with an average 25% reduction in their electricity bills by way of:
  1. Spreading the cost of Ontario's clean energy investments over the expected lifecycle of the generation infrastructure assets (i.e. global adjustment); this is expected to account for 18-19% of the overall reduction,
  2. Shifting the cost of the Ontario Electricity Support Program (OESP) and most of the Rural or Remote Rate Protection (RRRP) social program costs from ratepayers to taxpayer-funded programs,
  3. An 8% rebate equal to the provincial portion of the HST, which took effect on January 1, 2017.

- The OFHPA requires the IESO to create and maintain a variance account for the global adjustment (referred to in the OFHPA as a 'regulatory asset') to be recovered from the ratepayers, but the OFHPA does <u>not</u> establish any accounting definitions for this variance for financial reporting purposes

- By way of this government's policy decision, the 8% rebate and the social programs will be funded from the tax-base (not the rate-base); costs incurred, starting in 2016-17, have been accounted for as an expense in the Province's consolidated financial statements.

Ontario Fair Hydro Plan

Tax Base

- 8% rebate (started 1/1/17)
- Ontario Energy Support Program*
- RRRP*
- First Nations On-Reserve Credit*
- Affordability Fund*

Rate Base

- Global Adjustment Refinancing

Global Adjustment (GA) Refinancing

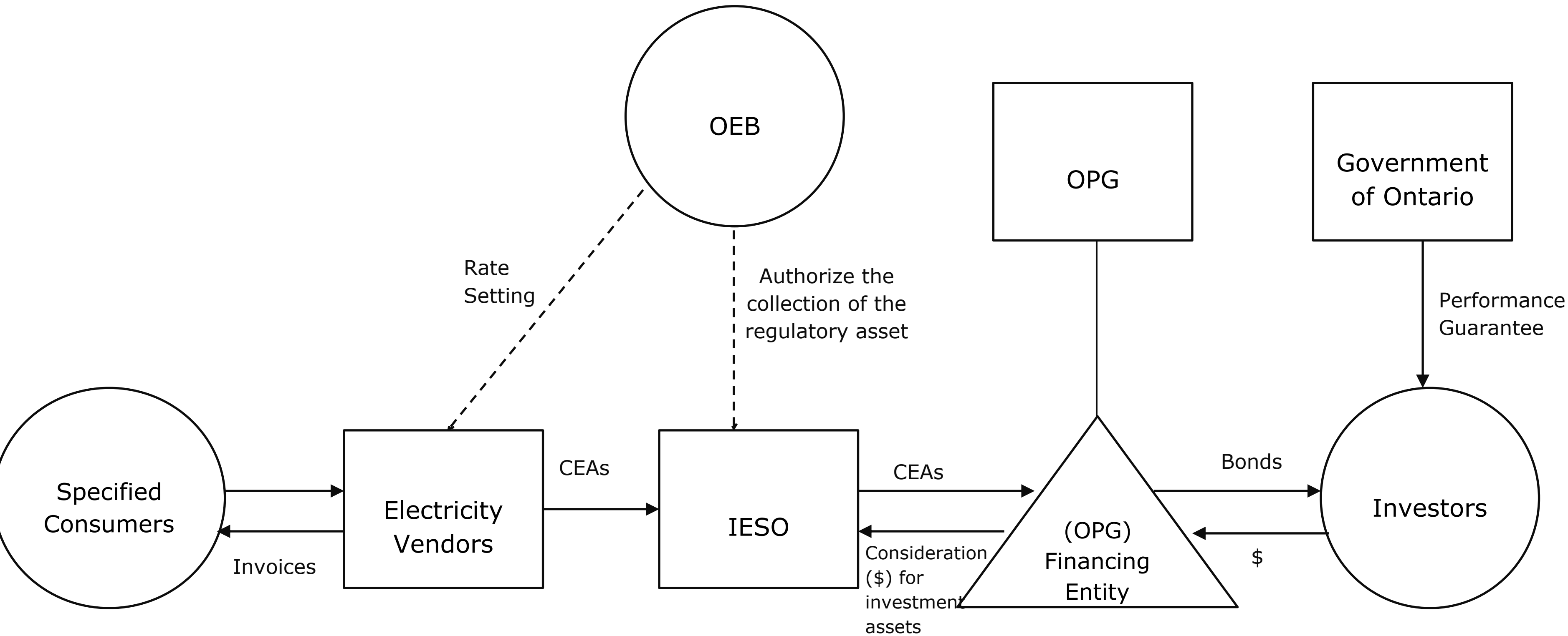
- Under the OFHPA, while the majority of generators are under 20-year contracts, the amounts paid by the IESO to the generators will be recovered from specified ratepayers over a longer period to reflect the expected period of benefits derived from these generating assets (as confirmed by analysis by external parties)
  - Electricity consumers will benefit from the ongoing useful life of these generating assets, and will be responsible for the costs of these assets over the same timeframe

- Refinancing the GA, which pays for the bulk of the recent investments in the electricity system, 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.

- Rate increases are capped at inflation until 2021, after which rates will be recovered by including a component charge to cover the refinancing of the GA (principal and interest) over the following 25 years.

- The GA refinancing program ensures that costs are borne by the rate-base, as the beneficiaries of the electricity system, and not the tax-base.

Global Adjustment Refinancing



Rate-regulated Accounting

- Public Sector Accounting Standards are silent on the use of rate-regulated accounting; it neither explicitly permits nor prohibits its recognition, measurement, presentation or disclosures

- Within the PSAB Handbook, preparers are permitted to apply professional judgment in the application of other sources of GAAP, including US GAAP which is the only North American guidance on rate-regulated activities

- Under US GAAP, the regulatory asset created under the OFHPA satisfy the asset definitions under PS1000 as a direct result of the legislative right to collect past costs through rate setting on based on expected power consumption from future ratepayers

- Additional evidence supporting the classification of rate-regulated assets as assets in other frameworks (similar to PSAS) is contained within FAS71 (para.58) under FASB, and the current application of the GAAP hierarchy with those under Part V using rate-regulated accounting

- Rate-regulated assets possess characteristics more consistent with that of a financial assets (i.e. used to discharge existing liabilities and not for consumption in the normal course of operations)

Impact on Net Debt

- The GA refinancing is a transaction that will be recovered through a charge to ratepayers through their electricity bills over the service life of the power generating assets; it is not a transaction that has recourse to the tax-base.

- Under the PSAB Handbook, net debt is a measure of “the government's future revenue requirements and on its ability to finance its activities and meet its liabilities and contractual obligations”.

- Absence the recognition of the variance account under the OFHPA as an asset, the Province’s net debt would increase significantly, suggesting that the Province has a much higher future revenue requirement.

- Since the OFHPA regulatory asset is going to be recovered under statute from electricity consumers, not taxpayers, such an increase in net debt would be misleading and inaccurate to financial statement users based on the substance of the transaction.

Addressing Transparency

- The GA refinancing will be addressed through Ontario Power Generation (OPG) which will issue debt on the open market for approximately ½ of the projected variance to capitalize the IESO, and in exchange will receive the right to future revenues from consumers due to IESO under the OFHPA

- As a government business enterprise, OPG is reflected in the Province's consolidated financial statements on a modified-equity basis, such that it's assets and liabilities are not comingled with those of the Province

- The financial statements of OPG are publicly available and will contain all required presentation and disclosure of all material transactions undertaken during the fiscal year

- The IESO financial statements are also available publicly, as well as disclosed in Volume 2 of the Public Accounts of Ontario with proper disclosures

- Given the materiality, additional voluntary disclosures are also under consideration in the Province's consolidated financial statements.

Conclusion

- IESO's management, their Audit Committee, their Board of Directors, their external auditor and the Office of the Provincial Controller support the change in accounting policy adopted by the IESO in 2016 as a more transparent reflection of their operation.

- The OFHPA is a legislative vehicle to invoke the mechanics of a policy decision to provide electricity consumers with a rate reduction by extending the period of recovery of clean energy investments to align with the productive life of those assets, as opposed to the contract duration, and does not provide any guidance on the accounting for the variance account

- In evaluating the proper accounting for balances under the OFHPA, in the absence of guidance under PSAS, the application of US GAAP for rate-regulated activities is the most appropriate guidance, and is consistent with the primary sources of GAAP.

- The financial statement presentation of the Province best reflects the economic substance of the financial components of this government policy by reflecting assets, liabilities and net debt in accordance with the principles under PSAS.

Helping Vulnerable Electricity Consumers

- Fair Hydro Plan initiatives to help vulnerable consumers include:
  - Broadening Rural or Remote Rate Protection (RRRP) program to provide distribution charge relief for the customers of the costliest local distribution companies (LDCs).
  - Enhancing the Ontario Electricity Support Program (OESP) and working to ensure the program uptake is as close as possible to 100%.
  - Establishing a new First Nations On-Reserve Delivery Credit.
  - Establishing a new Affordability Fund which would support Ontarians who have difficulty paying their electricity bills to be able to access energy efficiency improvements.

- All of these initiatives would provide benefits to eligible consumers on top of the benefits they would receive from Global Adjustment (GA) refinancing.

- As part of the Fair Hydro Plan, these programs would be funded by provincial revenues, reducing regulatory charges for all Ontario ratepayers.
  - These programs would be funded by provincial revenues because they all provide targeted benefits to vulnerable consumers.

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Appendix

Enhancing the Ontario Electricity Support Program (OESP)

- The OESP would be enhanced by increasing its monthly credits by 50%, expanded to cover more low-income Ontarians, and increasing uptake to as close to 100% as possible.
  - Sliding Scale #1 outlines basic program benefits, and Sliding Scale #2 outlines enhanced benefits for Indigenous households, electrically heated households, and households with certain medically intensive medical equipment.
- The government intends to introduce legislation to enhance the OESP and to move forward in having OESP costs be funded by provincial revenues, reducing regulatory charges for all Ontario ratepayers.

Existing OESP Credit Scales

Sliding Scale #1	Household Size						
Income Bracket	1	2	3	4	5	6	7 +
< $28,000	$30	$30	$34	$38	$42	$50	$50
$28,001 - $39,000			$30	$34	$38	$42	$50
$39,001 - $48,000					$30	$34	$38
$48,001 - $52,000							$30

Sliding Scale #2	Household Size						
Income Bracket	1	2	3	4	5	6	7 +
< $28,000	$45	$45	$50	$55	$60	$75	$75
$28,001 - $39,000			$45	$50	$55	$60	$75
$39,001 - $48,000					$45	$50	$55
$48,001 - $52,000							$45

Proposed +50% OESP Credit Increase*

Sliding Scale #1	Household Size						
Income Bracket	1	2	3	4	5	6	7 +
< $28,000	$45	$45	$51	$57	$63	$75	$75
$28,001 - $39,000		$40	$45	$51	$57	$63	$75
$39,001 - $48,000			$35	$40	$45	$51	$57
$48,001 - $52,000					$35	$40	$45

Sliding Scale #2	Household Size						
Income Bracket	1	2	3	4	5	6	7 +
< $28,000	$68	$68	$75	$83	$90	$113	$113
$28,001 - $39,000		$60	$68	$75	$83	$90	$113
$39,001 - $48,000			$52	$60	$68	$75	$83
$48,001 - $52,000					$52	$60	$68

***Note:** The proposed higher scale, including the amounts in circles are proposed and will be refined in consultation with the OEB.

Broadening Rural or Remote Electricity Rate Protection (RRRP)

- Rural or Remote Rate Protection (RRRP) provides a rate subsidy to rural or remote residential customers who are faced with higher distribution costs compared to urban areas.
  - The RRRP is currently provided to approximately 350,000 Hydro One R2 residential customers in Ontario.

- The Province would expand the RRRP to provide distribution charge relief to additional hydro customers served by local distribution companies (LDCs) with the highest distribution rates, including: Hydro One R1, Northern Ontario Wires Inc., Lakeland Parry Sound, Chapleau PUC, Sioux Lookout Hydro, InnPower, Atikokan Hydro and Algoma Power. This would extend RRRP availability to about 800,000 customers.

- The new benefits would vary from LDC to LDC. For example:
  - A Hydro One R2 customer consuming 2,500kWh a month would see distribution cost reductions of around $75 a month.
  - A Hydro One R1 customer consuming 1,000kWh a month would see distribution cost reductions of around $18 a month.
  - An InnPower customer consuming 1,000kWh a month would see distribution cost reductions of around $12 a month.

- The government intends to introduce legislation to broaden the RRRP and to move forward in having RRRP costs be funded by provincial revenues, reducing regulatory charges for all Ontario ratepayers.

First Nations On-Reserve Delivery Credit

- In 2016, the Minister of Energy asked the Ontario Energy Board (OEB) to develop options for a First Nation delivery credit for households.

- The OEB, engaging with First Nations, including remote communities, the distributors serving them, and consumer groups, developed the following recommendations:
  - Eliminating the delivery charge for all on-reserve First Nations households and removing the monthly service charge for customers of licensed distributors which charge a bundled rate. The OEB estimates this would provide residential customers an average monthly benefit of $85.
  - Automatically qualify on-reserve First Nations households (~21,500 customers).

- The government intends to introduce legislation to create the First Nations On -Reserve Delivery Credit and to move forward in having its costs be funded by provincial revenues, reducing regulatory charges for all Ontario ratepayers.

Establishing a New Affordability Fund

- The Affordability Fund would assist electricity customers who cannot qualify for low-income conservation programs and need financial assistance to undertake energy efficiency improvements.

- The Affordability Fund would provide LDCs with an additional tool to help customers in need. LDCs would use the Fund to provide support to customers for energy efficiency improvements to help reduce their future electricity bills.

- Measures supported by the Fund are expected to be similar to those available under the existing low-income conservation program, such as energy efficient lighting and appliances and, for electrically heated homes, insulation and weather stripping. Cold climate air source heat pumps would also be an eligible measure.

- The Province intends to work with Hydro One, in consultation with all other LDCs, to establish an independent Trust to serve as the administrator of the Affordability Fund.

- The Province would pay for the Fund through provincial revenues.