GA Refinancing

OPCD Accounting Paper DRAFT Outline:

Purpose:

The purpose of this document is to summarize the preliminary views of the Office of the Provincial Controller in accounting for the Global Adjustment Deferral Account on the Province's consolidated financial reports.

Background:

- Provincial CFS –
  - prepared on PSAS basis, focus on fair and transparent reporting of the economic substance of government's activities and financial position.
  - RRA represent economic inflows and outflows (Appendix: 'what is RRA – recognized under different GAAPS, reference to CICA Research Project, IASB Project – no requirement for Independence of Regulator, different types of RRA – leg and those subject to prudence).
  - Application of GAAP Hierarchy where accounting standards do not specifically address a type of transaction
  - PSAS conceptual framework under review; accounting standards subject to change; analysis based on current accounting standards and currently available information.
  - PSAS definition of Asset

- Key entities:
  - Ministry of Energy – establishes legislation, provide provincial guarantee, etc.
  - IESO – Nature of IESO, types of RRA
  - OPG- Nature of OPG, types of RRA (O.Reg 53/05 legislated assets as well as assets subject to prudence review)
  - OEB - The OEB has broad jurisdiction as the administrative tribunal responsible for regulating the electricity industry in Ontario. It has jurisdiction to set payment amounts for regulated entities which has been conveyed by the legislature under which the OEB authorizes the establishment of accounts as well as the power to dispose of the amounts recorded in such accounts. (Again, confirm that Independence not required under accounting standards)

- Classification of entities –
  - IESO (OGO-NFPO, not GBE but no funding received from the Province)
  - OPG
  - OEB (OGO)
- Legal opinion – consider requesting for OPG and IESO assets to reflect recoverability (to justify accounting for assets on Province's books)
- Intro to Fair Hydro Plan:

Intro to FHP:

On March 2, 2017, the Province of Ontario (the Province) announced Ontario's Fair Hydro Plan (the Plan) aimed at reducing electricity bills by 25 percent on average for all residential consumers in the province. As part of the Plan, the Province has proposed financing a portion of the Global Adjustment costs over a longer time period for Regulated Price Plan eligible customers (e.g., residential, farm, small businesses).

Why structured this way

- The nature of the recoverable is an asset, but to be reported as a regulatory asset, OPG would have had to have incurred the cost itself. Since the costs would not have been incurred directly by OPG, the proposed structure will allow it to record an intangible on its books through consolidation of the Trust, coincidental with the adoption of rate regulated accounting by the IESO under which it will appropriately reflect the deferred amounts, prior to sale to OPG, as regulatory assets.
- Insert support for reporting GA financing costs as a RRA by the IESO (does not have to be related to interest capitalized on a capital asset to be a RRA
- Insert commentary confirming that activities of generators do not have to be regulated in order for the IESO to recover their costs under RPP, or for any deferred portion thereof to be considered part of a RRA.

IESO

As of January 1, 2016, the IESO changed its accounting policy to recognize the economic impacts of rate regulation and now applies guidance from US GAAP Topic 980, *Regulated Operations,* as PSAS does not have any guidance for entities with rate-regulated activities.

- Specific parts of the IESO's activities which are subject to rate regulation include (smart meters, IESO's operating cost, GA costs which are recoverable through RPP, and pension related costs. **(IESO details to follow)**

IESO concluded that it met the requirements of PS2120.02, which allows them to reflect the impacts of rate regulation, as it is considered that the change of accounting policy in its 2016 financial statements resulted in a more appropriate presentation of transactions in the financial statements. The change was made to better reflect the economic substance of certain types of expenses that may not be directly recovered through the normal revenue requirement model.

The regulatory framework in Ontario relating to the generation and sale of electricity will be significantly impacted by the proposed Act. Currently, a substantial amount of the energy purchased from the generators is collected by IESO from the local distribution companies through the customer billing, with the remaining being recovered through variance accounts over a period of 12 months maximum. As mentioned above, the effect of the proposed Act is to defer the collection of a total estimated amount of $28 billion (plus interest) of energy purchased from the generators over a period of 30 years.

The proposed Act will not permit IESO to collect the funding shortfall before May 1, 2021 and the recovery process will be established through regulations, similar therefore to those accounts of OPG's which are also rate regulated and established through regulations under O.Reg. 53/05. As such, the OEB has no discretion with respect to the continuation of these accounts and has no discretion to evaluate prudence.

The IESO has assessed that despite the long-term deferred recovery plan, the uncollected energy costs should qualify for deferral as a regulatory asset under the proposed legislation as they would continue to meet the criteria applied by IESO in regards to its financial reporting (ASC 980):

(a) It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

(b) Based on available evidence, the future revenue will be provided <u>to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.</u> If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

Deferred recovery plans are plans adopted by regulators or legislations in response to significant increases in costs (e.g. purchased power costs). These plans typically provide for rates to remain fixed or increase moderately with a variance account mechanism to capture costs in excess of the level allowed in current rates. A regulated utility subject to such plans is required to consider whether it continues to meet the criteria that allow it to use the guidance for regulated operations of Topic 980, especially criteria ASC 980-10-15-2 (b).

The proposed plan for the recovery of purchase power costs over a 30 year period is considered a deferred recovery plan as the rates for the first four years will remain fixed and subsequently the rates will increase moderately with a variance account to capture energy costs in excess of the level allowed in current rates.

(a) 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.

(b) The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products.

(c) In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs."

(d) IESO management has concluded that the IESO can recognize a regulatory asset related to the variance account created by the proposed Act.

The variance account created by the proposed Act is subject to rate regulation by the OEB and the variance account will be established with the right to collect funds against the variance amount in the future. In these circumstances, the IESO is able to establish a regulated asset. The IESO financial statements are prepared in accordance with Canadian public sector accounting standards. Although PSAB does not provide specific guidance on rate regulated accounting, it does allow for guidance to be followed from other accounting frameworks. IESO has applied guidance from United States Generally Accepted Accounting Principles (US GAAP) Topic 980, Regulated Operations in its accounting policies.

IESO management has concluded that the OPG Trust to be established would not be controlled by the IESO and therefore is not subject to consolidation by the IESO. Based on the 11 indicators of control as defined in Section PS 1300 *Government Reporting Entity*, there is no evidence of control by the IESO for the OPG Trust either collectively or individually. The IESO will not have the power to govern the Trust, nor have ongoing access to Trust's assets. The IESO will also not have any voting shares or future rights to the Trust nor the power to dissolve the Trust. Without control, the Trust is not subject to consolidation within the IESO financial statements.

Sale of the Regulatory Asset to OPG (Transfer)

(1) The IESO may from time to time, in accordance with this Act and the regulations, transfer a specified portion of the regulatory asset to a financing entity in accordance with this section.

(2) An agreement between the IESO and a financing entity in relation to the transfer of a specified portion of the regulatory asset shall provide for consideration of a payment by the financing entity to the IESO in an amount equal to the amount of the specified portion.

(3) Upon receipt by the IESO of the payment by the financing entity,

(a) the balance in the variance account shall be reduced by the amount of the payment;

(b) the regulatory asset shall be adjusted accordingly;

(c) the financing entity shall acquire a corresponding investment interest; and

(d) the IESO shall retain no further right, title or interest in the corresponding investment interest.

Although ASC 980-20-40 states that

"Derecognition Section provides guidance on determining whether and when an entity should remove an item from the financial statements. For example, the entity would derecognize an asset because it no longer has rights to the asset or it would derecognize a liability because it no longer has any obligation."

In the absence of clear guidance for the derecognition of regulatory asset under ASC 980, guidance from PSAS should be analyzed for the criteria for the derecognition of assets.

It should also be noted that PSASs provide limited guidance on derecognition of non-financial assets and liabilities. Section 3430 *Restructuring transactions,* which is applicable for fiscal years on or after April 1, 2018 with early application permitted, has guidance for the derecognition of assets and liabilities.

- Paragraph 21 states that individual assets and liabilities transferred in a restructuring transaction should be derecognized by the transferor if they no longer meet the definitions of assets and liabilities and applicable recognition criteria at the restructuring date.
- As stated in paragraph 24, when a transferor continues to be involved in the individual assets and/or liabilities it transferred to a recipient subsequent to the restructuring date, it would assess the nature and extent of its continued involvement against the definitions of assets and liabilities and applicable recognition criteria to evaluate whether derecognition of the asset and liability transferred would be appropriate and whether its continued involvement gives rise to a new asset or new liability that needs to be recognized.

Recognizing the proposed transaction is not a restructuring transaction, Section 3430, which has recently been issued by PSAB, provides current thinking in the application for the recognition and derecognition of assets and liabilities which is consistent with derecognition guidance in other aspects of GAAP. Accordingly, the analysis as to whether the regulatory asset transferred to the OPG Trust can be derecognized is based on the guidance in paragraph 21.

OPG

The design of the GA Financing Plan includes OPG administering the financing associated with the Plan based on OPG's participation in the market and regulatory knowledge. and the foreseen accounting for financing activities on OPG's financial statements (i.e. consolidation of the Trust). Having exercised discretion over the decision to participate in the Fair Hydro Plan, OPG will establish a Financing Entity Trust (the Trust) to finance and administer the Global Adjustment costs through a mixture of external financing and an equity injection from the Ontario Financing Authority. It is expected that OPG will control the Trust for accounting purposes and that its financial position and results will be consolidated within OPG's consolidated financial statements. For purposes of the Province's consolidated financial statements, the intangible assets reported on the books of OPG would be reflected on the CFS under PSAS through modified equity consolidation of OPG.

As the sole unit holder of the Trust, OPG will exercise discretion over all decisions over the activities of the Trust. For example, OPG is expected to have the ability to OPG will have the power to establish operating and capital budgets of the Trust, and to make decisions about the financing alternatives, duration, and the strategy to minimize financing costs, with no veto right by the Province. While the Province maybe involved in the Board of Trustees, OPG is expected to have the majority vote to support its controlling position.

Once drafted, the related Regulations, Trust documents and various agreements are expected to confirm the expectation that OPG will have significant variability and exposure from the activities of the Trust relative to the rate of return that OPG would recognize from its role as the Financial Services Manager of the Trust. The performance fee will be meaningful and allow OPG to make decisions that will significantly impact its returns.

The purpose of the Trust is to allow OPG to earn a return on the Intangible Asset from the IESO by effectively managing financing to earn a spread, earn management fees, and earn interest fees. For the reasons noted above, OPG has control over the decisions to be made about the relevant activities. It is expected that OPG will have both power over the Trust (i.e. as a Principal, not an agent), exposure or rights to the variable returns from the Trust, and the ability to use its power to affect OPG's returns from its involvement with the Trust. OPG is expected to have the ability to use its power over the relevant activities of the Trust to affect its returns from its involvement with the Trust through the variable fee component. The performance fee will be meaningful and allow OPG to make decisions that will significantly impact its returns. Neither the OEB nor any other party can discretionally reduce the management fee or performance fee except due to a calculation error. The approval by the Ontario Energy Board of the Financial Services Manager (i.e. OPG's) fees as described in *Part IV – Implementation - Section 14.4 Same, Board Approval* will not allow them to change or limit the management fee structure, but only ensure that it is prudent by ensuring it is calculated in accordance with the Regulations.

Relevant activities:

The relevant activities of the Trust are:

- To evaluate and make decisions on financing alternatives, duration, and the strategy to minimize financing costs.
- To effectively manage funding obtained through the capital markets and be able to make or lose any spread from financing
- To provide funding to the IESO in return for an interest in a future cash flow stream
- To obtain funding through the capital markets and other vehicles available to OPG to be able to provide the IESO funding.
- To make capital and funding decisions required to meet the Fair Allocation Plan objectives as set out in Legislation
- To finance the requirements associated with the short-fall amount
- To raise debt, pay bond debt holders, and determine capacity for the Trust to raise additional financing

OPG has the ability to direct the relevant activities of the Trust. OPG can amend the Financing Plan at any time, without approval from the Minister. Further, if the Minister of Energy chooses not to continue with OPG's current Financing Plan, OPG can withdraw its Financing Plan, without impacting the existing debt and related intangible assets that is already in the Trust. The Province would just appoint a new party to participate in future securitizations and OPG would continue to manage the debt that already exists in the Trust. If future financing transactions are with a different SPV, a separate consolidation analysis would be prepared at that time as to which party if any would consolidate the SPV.

The indemnification provided to the Trust by the Minister of Finance on behalf of the Province as described in *Part I – General - Section 5.3 Guarantee, indemnification Protection and assurances* will be subject to terms and conditions in a separate Provincial support agreement. The guarantee is expected to be in place only in the event of a Payment Guarantee Event, such as if the Legislative Assembly of Ontario repeals the Fair Hydro Act or amends the Act in a way that adversely impacts the ability of the Trust to fully recover an intangible asset in order to pay the obligations of the Trust.

At the Provincial level, cash flow from the Trust's intangible asset will include interest income that is equal to the interest expense charged by the debt providers. Interest expense on the debt will be recovered through rates charged to ratepayer commencing with the recovery period.

The Regulations are expected to provide further details related to the 'Fair Allocation Plan' which will be based on high level Principles and Parameters of the Plan, including the attribution methodology. The Legislation or Regulation determines the following principles:

- 25% Reduction (June 1, 2017) where the average bill will reduce by 25% including HST and social programs
- Inflation Period (November 2017 – April 2022) where bill increases are capped at inflation
- Straight-line Increase Period (May 2022 – April 2027) where bills increased at a straight-line rate (i.e., 8% per year) which is set so that borrowing will not exceed the Trust's capacity.
- Amortization Period (May 2027 – April 2047) where debt built up over the previous periods is repaid by ratepayers.

OPG will determine the manner in which the intangible asset, once purchased from the IESO will be collected and the period of collection. The recoverability of the existing intangible assets cannot be impacted by the Province. Although the Province may determine the Principles and Parameters around the 'Fair Allocation Plan', it does not impact the activities of the Trust once OPG has purchased the intangible asset.

- OPG's plan for managing the assets of the Trust will be dictated through a 'Financing Plan'.
- The Financial Services Manager (i.e. the Trust) shall provide the Financing Plan to the Minister. The Financing Plan is expected to follow Principles as stipulated in the Legislation which indicate that the assumptions must be reasonable and that the Trust has the power to determine what is reasonable and cost-effective. The Trust makes all the decisions in determining the relevant activities as listed above.
- OPG can amend the Financing Plan at any time without the approval of the Minister.
- The 'Fair Allocation Amount' ("FAA") is the amount of the deferral for the reference period and includes finance amounts. The current Legislation dictates that the Minister of Energy is to calculate the FAA.

This does not impact OPG's relevant activities in the Trust as OPG's variable returns are based on financing decisions which are not dictated by the FAA. OPG can choose to accept or reject the purchase of the intangible asset which is based on the Fair Allocation Amount.

(INSERT ANALYSIS SUPPORTING NON-CONTROL OF THE TRUST BY THE PROVINCE, despite guarantee)

Understanding of the transition of asset from RRA in IESO to Intangible Asset in OPG, including interest/admin charge component and any possible impact on Public Accounts.

- Consider also performance metrics for OPG, and potential balance of RRA on IESO books at year-end.

**Potential impact of 3070 and 3420 on transactions if no RRA (EY)

- ** Potential impact if OPG no longer controls the Trust (replaced as Financial Services Manager)

The Minister of Energy will have the ability to replace the Financial Services Manager (OPG) if there is a failure to perform. There will be a bifurcation of roles where the Province could not remove OPG as manager/administrator with respect to the existing debt placed by the Trust, but could remove OPG's responsibility/right to prepare the Financing Plan going forward. The ability for the Minister of Energy to remove OPG as the Financial Services Manager should not impact the recoverability of existing intangible assets and the IESO is required to continue to make cash payments for interest to the Trust for the existing debt. Principal repayments on existing debt will continue to be repaid by ratepayers to the Trust in accordance with the terms of the issued debt.

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** Impact if GA deferral deemed an unconstitutional tax at some point during the deferral/recovery period. (EY- OPG EY)

List of (proposed) Appendices:

- 'What is RRA – recognized under different GAAPS, reference to CICA Research Project, IASB Project – no requirement for Independence of Regulator, different types of RRA – leg and those subject to prudence).
- PSAS references to GAAP Hierarchy, with accompanying narrative explaining how applicable (IESO)
- PSAS references:
  - Consolidation of OGOs, GBEs
  - Definition of Asset
- Entities – extracts on IESO, OPG, IEB
- Extracts/summary of draft legislation
- Legal opinions(?)
- IESO accounting paper
- OPG accounting paper
- Accounting entries
- Illustration of fiscal impacts if accounted for as RRA vs. period cost with future recovery