The Recognition of Ontario Power Generation Inc.'s Assets and Liabilities Resulting from Rate Regulation

Conclusion

Based on the arguments presented in this paper, OPG is of the opinion that non-recognition of OPG's variance and deferral accounts resulting from rate regulation would not satisfy the requirements of International Financial Reporting Standards (IFRS) to report revenue, expenses, financial assets and financial liabilities.

Management believes that where OPG has under-recovered its revenue from ratepayers and the balances in the Ontario Energy Board (OEB) approved variance and deferral accounts, and those established under Ontario Regulation 53/05 of the OEB Act, 1998, (Reg. 53/05), are in a receivable position that recognition on the statement of financial position meets the International Accounting Standards Board's (IASB) definition of a financial asset under International Accounting Standard (IAS) 32, Financial Instruments: Presentation. The financial asset should be measured at its expected present value.

Management also believes that where OPG has over-recovered amounts from ratepayers and the balances in the OEB approved variance and deferral accounts, and those established under Reg. 53/05, are in a liability position that the recognition on the statement of financial position meets the definition of a financial liability under IAS 32. The financial liability should be measured at its expected present value.

These conclusions are based on OPG's right, as a prescribed generator operating prescribed facilities, to fair compensation. Fair compensation to OPG as set out in the OEB Act is comprised of two elements: (1) the right to recover all prudently incurred costs, and (2) the right to a fair return on invested capital. Accordingly, OPG's revenue is defined as a function of the cost incurred to provide service. These conclusions are also based on the fact that the collection and repayment of amounts in the variance and deferral accounts is not dependent on the provision of future service, and is for electricity already generated, delivered and consumed.

Background

Currently OPG recognizes approximately $850 million of assets and $250 million of liabilities comprised of variance and deferral accounts established under Reg. 53/05 and orders by the OEB. The scope of this paper addresses such accounts.

OPG is to adopt IFRS effective January 1, 2012. Currently under IFRS, there is no specific guidance on accounting for assets and liabilities resulting from rate regulation. Accordingly, under IFRS, recognition of OPG's assets and liabilities resulting from rate regulation will be assessed under the existing accounting guidance.

The purpose of this paper is to identify OPG's legal rights and obligations as a prescribed generator that operates prescribed generation facilities. The paper also identifies relevant IFRS accounting guidance. The paper then demonstrates how OPG can recognize its assets and liabilities resulting from rate regulation within the context of current IFRS guidance.

Legal Context

OPG commissioned Torys LLP to describe the legal basis of OPG's assets and liabilities resulting from rate regulation. A draft copy of the Torys letter is attached. Torys LLP have determined that, under law, the OEB is to set electricity rates on the basis of the "just and reasonable" standard. The Supreme Court of Canada has described just and reasonable rates as those that would be fair to the consumer and would secure the company a fair return on capital invested.

As a prescribed generator that operates prescribed generation facilities, under law, OPG has the right to fair compensation. Fair compensation to OPG is comprised of two elements: (1) the right to recover all prudently incurred costs, and (2) the right to a fair return on invested capital. Accordingly, OPG's revenue is defined as a function of the cost incurred to provide service.

To assist the regulator in fulfilling its mandate to provide utilities of the right to recover prudently incurred costs, the OEB uses variance and deferral accounts as tools to deal with uncertainty, including circumstances that are difficult to forecast and that may be beyond the control of OPG. These accounts are based on the standard of just and reasonable rates. The use of variance and deferral accounts mitigate forecasting risk and, therefore, protects the rights and interests of both the ratepayers and OPG. Ratepayers pay a fair rate and OPG receives fair compensation.

As part of the OEB's rate-setting function and its powers, the OEB can grant the right to OPG for OPG to establish variance and deferral accounts, and the right to OPG for OPG to record underestimates and overestimates of specific costs or revenues in such variance and deferral accounts. With the establishment and use of variance and deferral accounts comes the right to OPG that the OEB will undertake a review of the variance and deferral accounts, and approve, in a decision and order, the amounts OPG has the right to recover or obligated to pay.

In summary, OPG has two fundamental legal rights. OPG has the legal right to revenue by recovering all costs prudently incurred to generate and provide electricity consumed by the ratepayer. OPG also has the legal right to bill and collect all prudently incurred costs as a means of protecting its first legal right to recover revenue defined as a function of such costs. As discussed in the Torys LLP legal letter, OPG would be able to recover or be obligated to disburse prudent amounts recorded in a deferral or variance account either through a rate or via payment of an amount determined by the OEB.

The Rate Setting Process

The OEB has the legal power and responsibility to establish just and reasonable rates for the electricity generated by OPG's prescribed facilities. Normally this is done in the context of the regulatory cycle that OPG is subject to as a prescribed generator.

OPG may apply to the OEB, or the OEB may require OPG to apply, for new payment amounts from time to time. The application is typically based on estimated, forecasted costs and production. The OEB then holds an adversarial hearing to consider the application, during which the application is subject to vigorous review and scrutiny by OEB staff members, intervening parties and the OEB panel itself. After considering the evidence and arguments presented, the OEB panel issues a Decision and Order setting out the panel's decisions with respect to each of the aspects of the application, including the various requests for cost recovery that normally comprise such an application.

The new payment amounts for which OPG applies are for future rates to recover future costs for future production. For example, during 2010 OPG applied to the OEB for rates to recover the estimated, forecasted costs of generating the estimated, forecasted electricity from its prescribed generation facilities in the years 2011 and 2012. A hearing was held and OPG has received the OEB's decision on the 2011 and 2012 rates. Accordingly, the 2011 and 2012 rates established by the OEB are set to recover the estimated costs, not the actual costs, of generating electricity during 2011 and 2012. During 2011 and 2012 OPG may incur actual costs that are greater and/or less than the estimated costs upon which the rates are based. Accordingly, OPG may recover less or more than the costs for which it has a right to recover. As mentioned, variance and deferral accounts are tools used by OPG and the OEB to track these underestimates and overestimates of specific costs so as to enable the amounts of the variances and deferrals to be recovered by OPG or reimbursed to ratepayers. Through the use and disposition of the deferral and variance accounts OPG recovers what it is entitled to recover and/or fulfils its obligation to repay any over-recovery of costs.

The use of variance and deferral accounts ensures that OPG recognizes only the revenue it is entitled to recognize for the electricity generated and consumed by the ratepayers. For example, recognizing the uncertainties associated with fluctuating world uranium prices, and with a view to protecting OPG and ratepayers, the OEB approved the establishment of a variance account to capture the differences between forecast and actual nuclear fuel expenses. In this way, if OPG's actual nuclear fuel costs prove to be higher than the forecasted costs upon which the revenue requirement was set then OPG would be able to track the difference and recognize the higher revenue amount it is entitled to collect to recover its costs to generate the electricity already provided to and consumed by the ratepayers. Alternatively, if OPG's actual nuclear fuel costs proved lower than the forecasted costs upon which the revenue requirement was set then OPG would be able to track the difference and recognize the lower revenue amount it is entitled to collect to recover its actual costs to generate the electricity already provided to and consumed by the ratepayers.

The Accounting Guidance

Currently there is no accounting standard in IFRS that specifically addresses accounting for assets and liabilities resulting from rate regulation. The International Accounting Standards Board's (IASB) Framework for the Preparation and Presentation of Financial Statements (the Framework) defines assets, liabilities, equity, income and expenses. IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, requires reference be made to the Framework in the absence of a specific standard.

The IASB's Framework states that information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, OPG's statement of financial position should represent faithfully the transactions and other events that result in assets, liabilities and equity of OPG at the reporting date, which meet the recognition criteria.

In addition to the Framework, OPG has referred to other IASB accounting guidance, including IAS 18, Revenue and IAS 32.

Recognition of Revenue

The recognition of OPG's variance and deferral accounts provides for the accrual of unbilled revenue. It is probable that the economic benefits of any unbilled revenue will flow to OPG. And, the recognition of OPG's variance and deferral accounts contributes to the faithful representation of OPG's revenue, and its rights to resources to be received and obligations to be paid in the future. OPG's stakeholders include its shareholder, debt holders, creditors, ratepayers, the OEB, potential investors, and credit analysts. All of these stakeholders have an interest in the amount of costs incurred that OPG has rights to recover and the amount of over-recovery that OPG is obligated to repay.

International Accounting Standard 18, Revenue (IAS 18) provides guidance on the recognition of revenue.

Revenue is defined in IAS 18 as the gross inflow of economic benefits during the period arising in the course of ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants. Revenue includes only the gross inflows of economic benefits received and receivable by an entity.
Paragraph 14 sets out five criteria, all of which have to be met, to recognize revenue from the sales of goods. The criteria are:

(a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
(b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

(c) The amount of revenue can be measured reliably;
(d) It is probable that the economic benefits associated with the transaction will inflow to the entity; and
(e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

Electricity cannot be stored so it is provided to and consumed by the ratepayer upon generation. Accordingly, the first two criteria are met as the risks and rewards of ownership are transferred and there is no continuing involvement or control by OPG. The amount of electricity generated and provided to the ratepayers is metered and, therefore known. A combination of the electricity generated, the estimated rate established through the rate setting process and the tracking of underestimates and overestimates in the variance and deferral accounts, provides for the reliable measurement of the actual revenue to which OPG is entitled.

For revenue to be recognized it is to be probable that the economic benefits of the transaction will flow to OPG. The electricity industry has existed for more than 100 years with no indication that it will not continue to exist in the future. Society is very much dependent on electricity as a basic essential service. OPG expects to generate electricity indefinitely from its generation facilities and that the related supporting infrastructure will remain in place at its generation facilities for as long as required to do so. OPG's business plan demonstrates the customer demand and cash flows to support these assumptions. OPG can forecast with a high degree of accuracy the consumption of electricity to be generated.

OPG uses approved variance and deferral accounts to record under and over estimates of costs incurred, which measure the additional revenue it is entitled to receive from ratepayers and the additional funds it has collected and obligated to return to ratepayers. The OEB reviews the costs recorded in the variance and deferral accounts for prudency and approves the amounts to be collected and refunded by OPG. Amounts to be collected by OPG are rights to receive cash from ratepayers. Amounts to be refunded to ratepayers are obligations to deliver cash to ratepayers. Any differences between the amounts recorded in the accounts by OPG and the amounts approved by the OEB to be collected and refunded would be measurement differences.

Typically, the collection and refunding of these amounts are through the increase and decrease of future rates for future electricity. However, it is recognized that the collection and payments are not dependent on the provision of future service. The OEB has both the jurisdiction and the obligation to establish a rate or payment amount that allows OPG to recover its costs in the event there is no output by OPG's prescribed facilities. The OEB has jurisdiction to set payment amounts on a non-volumetric basis.

The Independent Electricity System Operator (IESO) fulfills its statutory mandate by acting as a clearinghouse to settle the flows of money among participants in the Ontario electricity market. Distributors collect money from customers. The money is received by the IESO, and the IESO is responsible for ensuring OPG is paid the amounts it is entitled to be paid for the injection of electricity into the IESO-controlled grid. The market rule requirements that apply to persons seeking authorization to participate in the Ontario electricity market are key to the IESO's ability to collect amounts and remit payment to OPG.

The letter from Torys LLP describes in detail the roles and responsibilities of the OEB and the Independent Electricity System Operator (IESO) in ensuring OPG both receives its revenue and repays its obligations. These roles and responsibilities are reinforced through the Market Rules that establish the contractual arrangements for all of the market participants. The Market Rules govern the electricity market in Ontario, including OPG's invoicing the IESO for electricity and the IESO's payment to OPG.

OPG's costs incurred to generate the electricity are reliably measured through its existing accounting systems. The use of variance and deferral accounts enhances the measurement of these costs and mitigates forecast risk, therefore, protecting the rights of OPG and the ratepayers. The variance and deferral accounts are subjected to a rigorous review process by the OEB and other external parties. Once electricity is generated and consumed there are no further costs to be incurred that are associated with such electricity.

Recognition of Assets

With the recognition of revenue on the income statement there is an associated recognition of an asset on the balance sheet. Under the Framework an asset should be recognized if based on a past event, a probability of future economic benefit exists, and the realization of the future economic benefit is in an entity's control. Furthermore, a financial asset is one that includes a contractual right to receive cash.

OPG believes that, based on the fact pattern outlined in this paper, and that the deferral and variance accounts are established based on a past event, OPG will recover amounts based on a rate or payment mechanism established by the OEB and the contractual arrangements established under the Market Rules. OPG is legally entitled to the recovery of prudent amounts, which is not dependent on providing future service, as indicated by the legal opinion by Torys LLP.

Where OPG has under-collected in relation to a revenue requirement OPG has a legal right to receive cash for the electricity generated and injected into the IESO-controlled grid. Typically, the collection of these amounts is through the increase of future rates for future electricity, and increases OPG's future cash flows. However, it is recognized that the collection is not dependent on the provision of future service. The recognized revenue is unbilled and the corresponding asset is an unbilled receivable. An unbilled receivable is an asset that meets the definition of a financial asset under IAS 32.

Recognition of Liabilities

Under IFRS, liabilities are defined as present legal or constructive obligations arising from a past event, which is probable to result in an outflow of resources to settle the obligation. Furthermore, a financial liability is one that includes a contractual obligation to deliver cash. Provisions are liabilities that have uncertainty as to the timing or amount of settlement and are addressed in IAS 37.

Ratepayers are entitled to just and reasonable rates. As consumers of electricity they are to pay the rates established by the OEB, which include OPG's prudently incurred costs, and a fair return on invested capital. Therefore, if OPG should collect amounts in excess of its prudently incurred costs and a fair return then the ratepayer has a right to be reimbursed in the amount of such excess.

When OPG over-collects its costs it has a present, legal obligation to refund or return amounts to the ratepayers either directly or through a reduction of future rates. The liability has arisen from past events because rates charged for electricity resulted in funds collected being in excess of the costs required to generate and provide the electricity. Typically, the refunding of these amounts is through the decrease of future rates for future electricity and in accordance with the contractual arrangements under the Market Rules. Therefore, the settlement of OPG's obligation will typically result in a reduction in its future cash flows. However, as already noted, the reimbursements are not dependent on the provision of future service.

OPG recognizes that when using variance and deferral accounts there are circumstances when it overestimates its costs. The nuclear fuel cost variance account referred to above is a good example. There can be periods when OPG's actual costs for nuclear fuel are less than the estimated costs upon which its revenue is determined. In such a circumstance OPG over-recovers costs and, therefore, over-collects revenue. Since OPG has the right to recover only its costs incurred, and a fair return, it is not entitled to recognize the additional funds collected as current period revenue. Instead, OPG is legally obligated to repay the over-collected funds to the ratepayers.

OPG is required by law to refund/reimburse over-recoveries of costs, such as nuclear fuel costs, to customers. This represents a legal obligation to refund amounts to customers in some fashion based on the past generation and consumption of electricity. This is consistent with Paragraph 62(c) of the Framework that states that settlement of a present obligation may occur through the provision of services, presumably for free or at a reduced price and based on future service requirements. This is how OPG typically remits an over-collected amount back to the ratepayers.

OPG can reliably estimate its obligation with a high degree of precision. OPG's costs incurred to generate the electricity, the funds it receives and the revenue it is entitled to earn, are reliably measured through its existing accounting systems. The use of variance and deferral accounts enhances the measurement of these costs, funds received, and revenue.

Recognition of a liability is also consistent with the principles in IAS 18. OPG is entitled to recover only prudently incurred costs in revenue. Since costs have not been incurred, OPG does not have a right to certain amounts collected and has not met the revenue recognition criteria of IAS 18. Payments from ratepayers through the IESO do not reflect the cost of electricity generated and consumed by ratepayers.

Other Matters – dependency on future generation

There have been questions and concerns raised about OPG's ability to realize the assets resulting from rate regulation. The concerns include the realization should not be dependent on the provision of future service. There have also been questions and concerns raised about liabilities resulting from rate regulation should not be recognized where there is no obligation to refund or repay other than through a reduction of rates when providing a future service. The conclusion expressed in the Torys LLP draft letter addresses the issue of future generation. And reads as follows:

"In the circumstance where OPG ceases operations and does not have any energy output from its prescribed facilities, it is our opinion that the OEB would have the jurisdiction and the obligation to establish a rate or payment amount that would allow OPG to recover or obligate OPG to disburse prudent amounts recorded in a deferral or variance account. Such a rate or payment amount would not have to be based on dollars per unit of electricity output from the prescribed facilities. This is no different than under normal operating circumstances."

"The OEB has broad jurisdiction in setting payment amounts for OPG and it would not be reasonable for the legislature to have given the OEB the legislative power to authorize the establishment of accounts without also giving the OEB the power to dispose of the amounts recorded in such accounts, including in circumstances where there is no future output. Moreover, to interpret the applicable legislation in a manner that only allows for payment amounts on a volumetric basis is in our view unreasonable because it would not be consistent with the rules of statutory interpretation."

Accordingly, OPG's right to recover prudently incurred costs and its obligation to repay over-collected amounts are not dependent on future generation and would continue to exist in the absence of future generation

Appendix A

A comparison of how assets and liabilities resulting from rate regulation are generally accounted for under current Canadian generally accepted accounting principles and how they are to be accounted for under IFRSs is contained in Appendix A.

Accounting Under IFRS for Assets and Liabilities Resulting from Rate Regulation

Current Practice

Under current Canadian generally accepted accounting principles, utilities generally account for regulatory assets and liabilities by means of a cost deferral model.

For example, for the test period a utility forecasts expenses at CU1,000 that get accepted by the regulator and included in the price of the product/service provided by the utility. During the test period the utility receives CU1,000 to cover the expenses through the provision of its product/service. The actual expenses incurred as part of providing the product service are CU1,099. The utility has the legal right to receive revenue to cover all of the expenses prudently incurred and the legal right to use a variance account to record the differences between the forecasted and actual expenses.

The utility generally accounts for this event as follows:

Debit Regulatory asset	CU99	
Credit Expense		Cu 99

Should the utility incur actual expenses of CU901 the utility generally accounts for this event as follows:

Debit Revenue	CU99	
Credit Regulatory liability		CU99

The regulator reviews the variance account, accepts the amount as being prudent, and orders the utility to recover the CU99 excess expense on a straight-line basis over three years or to pay back the CU99 over-collection of funds on a straight-line basis over three years. Therefore, the regulatory asset or the regulatory liability is amortized to the P&L over three years at CU33 a year.

Proposed Accounting Under IFRS

Assume the same situation as above. For example, for the test period a utility forecasts expenses at CU1,000 that get accepted by the regulator and included in the price of the product/service provided by the utility. During the test period the utility receives CU1,000 to cover the expenses through the provision of its product/service. The actual expenses incurred as part of providing the product service are CU1,099. The utility has the legal right to receive revenue to recover all of the expenses prudently incurred and the legal right to use a variance account to mitigate forecast risk to record the differences between the forecasted and actual expenses.

The utility accounts for the event as follows:

Debit balance sheet Unbilled Revenue Receivable	CU99	
Credit Income statement Current period revenue		CU99

To record the legal right to revenue in the amount that recovers the expense incurred and the legal right to receive increased future cash flows to collect the current period revenue by means of a legally binding settlement mechanism

Should the utility incur actual expenses of CU901 the utility accounts for this event as follows:

Debit Income statement Current period revenue	CU99	
Credit balance sheet Unbilled Revenue Receivable		CU99

To record the legally binding amount of revenue that the utility has the right to earn and the legally binding obligation that the utility has to pay by means of decreased future cash flows by means of a legally binding settlement mechanism

The regulator reviews the variance account, accepts the amount as being prudent, and orders the utility to recover the CU99, the amount that the actual expense exceeds the estimate, on a straight-line basis over three years or to pay back the CU99, the amount that the actual funds collected exceeds the expense to be recovered, on a straight-line basis over three years. Therefore, the unbilled revenue receivable or liability for over-collected funds is received or repaid over three years at CU33 a year as the increased or decreased cash flows materialize each year. In addition, the revenue is recognized on the basis of changes in assets and liabilities, which is consistent with the IASB's current exposure draft on revenue recognition.

Should the regulator determine that the amounts were not prudently incurred then an impairment of the asset or an increase in the liability would be recognized, and the amounts of future cash flows also would be adjusted accordingly.