Ontario

2016-17 Public Accounts

Technical Briefing

September 7, 2017

Purpose of today's briefing

1. Provide an overview of the results for fiscal 2016-17
2. Provide an overview of the issues on which the Auditor General has qualified her opinion as well as the Province's professional staff's interpretation of Public Sector Accounting Standards on these issues.
    a. Pension accounting
    b. Change in accounting for the market accounts of Independent Electricity System Operator (IESO)
3. Provide an overview of the issues raised by the Auditor General in the Other Matters section of her opinion as well as the Province's professional staff's view on these issues.

Preparation of the Financial Statements

- The consolidated financial statements are prepared by the Government of Ontario in accordance with the accounting principles for governments recommended by the Public Sector Accounting Board (PSAB).
- PSAB independently establishes accounting standards for the public sector in Canada.
- The objective of PSAB standards is to meet the needs of users of financial statements by providing the information needed for accountability and decision making.
- PSAB standards specify how transactions and other events are to be recognized, measured, presented and disclosed in a public sector entity's financial statements.
- PSAB recognizes that their standards cannot address every potential situation, and that it may be necessary to refer to other sources of guidance.

Summary 2016-17 Results

2016-17 Actual Results							
$ Billions		2016-17 Budget[1]	2016-17 Actual		2015-16 Actual[2]	Change from Budget	% Change
Revenues		138.5	**140.7**		136.1	2.2	1.6%
Expenses		141.8	**141.7**		139.7	0.1	-0.1%
	Reserve	1.0	**-**		-	(1.0)	
Annual Deficit		(4.3)	**(1.0)**		(3.5)	3.3	-76.7%
Net Debt			**(301.6)**		(295.4)		
Accumulated Deficit			**(193.5)**		(192.0)		

[1] 2016-17 Budget has been restated for BPS line-by-line reporting (no change to deficit)
[2] 2015-16 Actual has been restated to reverse the impact of regulated accounting for pensions

Ontario

Accounting for Jointly Sponsored Pension Plans

- Ontario Public Service Employee's Union Pension Plan (OPSEUPP) and Ontario Teachers' Pension Plan (OTPP) are jointly sponsored pension plans (JSPPs) where the Government of Ontario is a co-sponsor.
- The plans are funded on a 50/50 basis, co-managed by the sponsors, and decisions regarding benefits and contributions require negotiation and agreement between them.
- Since 2001-02, the Province's share of pension assets reflected on the audited consolidated financial statements of the Province has been based on a policy considered to be appropriate and consistent with PSAB standards related to accounting for retirement benefits, which have not changed since their inception in 2001.
- Under PSAB standards, an asset arises when the government's total contributions to a plan, including interest earned thereon, are greater than the pension expense recognized since the start of the plan.

Auditor General's Qualification on Pension Accounting

- The Auditor General qualified her opinion on the 2016-17 consolidated financial statements regarding the Province's accounting for the net pension assets of OTPP and OPSEUPP.
- The Auditor General's position is that a full valuation allowance should have been recorded in 2016-17 (and prior years) to reduce the net pension assets of OTPP and OPSEUPP to NIL.
- The Auditor General states that the Government does not have the unilateral right to use this asset because its ability to reduce future minimum contributions or withdraw any pension plan surplus is subject to agreement with the respective pension plan's joint sponsors.
- The Auditor General notes that Canadian Public Sector Accounting Standards require the Government to record a valuation allowance against this asset.

Impact of Auditor General's Qualification on Pension Accounting

($ Millions)	Province's Interpretation of PSAB standards	Impact of Auditor General Interpretation	Auditor General's Interpretation
Consolidated Statement of Operations			
Total Expenses	141,725	1,444	143,169
Annual Deficit	(991)	(1,444)	(2,435)
Consolidated Statement of Financial Position			
Net Pension Asset / (Liability)	11,033	(12,429)	(1,396)
Total Debt	333,102	0	333,102
Net Debt	(301,648)	(12,429)	(314,077)
Accumulated Deficit	(193,510)	(12,429)	(205,939)

Province's Position – Pension Accounting

- Based on professional staff's interpretation of PSAB standards, the government believes that pension assets for OPSEUPP and OTPP should be reported in order to fairly present the Province's financial position.
- The professional staff does not agree with the Auditor General's interpretation of PSAB standards that the Province must have a unilateral right to reduce contributions in order to record an asset.
- The Province has shared control over the pension plan and the existing agreements in place between the sponsors support the recognition of the pension asset.
- The professional staff does not believe that the Government has the right to withdraw any surplus from the plan, and has supported the value of the pension asset solely on the basis of being able to reduce contributions in the future.
- The Province has recorded the pension assets for OTPP and OPSEUPP in its 2016-17 consolidated financial statements and has restated the 2015-16 consolidated financial statements to recognize the pension assets.

Province's Position – Pension Accounting

- The professional staff's interpretation of PSAB standards is supported by its own research and analysis as well as:
  - The report of the Pension Asset Expert Advisory Panel (https://www.ontario.ca/page/pension-asset-expert-advisory-panel-report) released on February 13, 2017 stating that the Government should record an asset for its share of the surplus reported in the accounting valuations for each plan and that no valuation allowance is required.
  - An opinion from Deloitte LLP dated October 2, 2016 on OTPP, a summary of which is included in Appendix A, supporting the ability to recognize a pension asset in the absence of having a unilateral right to reduce contributions to the plan.
  - Analysis completed by EY as to whether any valuation allowance is required to be recorded for OTPP or OPSEUPP as of March 31, 2017. EY confirmed no valuation allowance was required for either plan.

- On June 12, 2017, the co-sponsors of OTPP (Ontario Teachers Federation and the Government) announced a 1.1% reduction in contributions effective January 1, 2018

Independent Electricity System Operator and Market Accounts

- Independent Electricity System Operator (IESO) is a not-for-profit, non-taxable corporation established pursuant to Part II of the *Electricity Act, 1998*.
- IESO prepares its financial statements in accordance with PSAB standards.
- IESO's financial statements are audited by KPMG LLP, who issued an unqualified opinion on the December 31, 2016 financial statements.
- 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).
- In 2016, IESO changed the accounting for the market accounts, recognizing the amounts to be settled as assets and liabilities, equal in amount. In prior years, these amounts were not reflected in the financial statements of IESO.
- IESO made the change to better reflect the amounts due to and from the market participants.

Independent Electricity System Operator and Market Accounts

- Additional background on IESO:
  - On January 1, 2015, IESO was amalgamated with Ontario Power Authority (OPA) and continued as IESO.
  - Prior to the amalgamation, OPA prepared its financial statements in accordance with PSAB standards.
  - OPA's last financial statements prior to amalgamation were audited by KPMG LLP, who issued an unqualified opinion on the December 31, 2014 financial statements.
  - OPA's audited financial statements included a segment of the market accounts. The inclusion of a segment of the market accounts was not raised as an issue by the Auditor General in her report to management or in her Annual Report.
  - OPA's audited financial statements also referred to the use of rate-regulated accounting. The use of rate-regulated accounting was not raised as an issued by the Auditor General in her report to management or in her Annual Report.

Auditor General's Qualification on IESO Market Accounts

- The Auditor General qualified her opinion on the 2016-17 consolidated financial statements regarding the change in Independent Electricity System Operator's accounting for the "market accounts".
- The "market accounts" are amounts owed to entities that generate electricity (e.g. power generators) and amounts due from entities that consume electricity (e.g. local distribution companies on behalf of their consumers).
- The Auditor General's position is that the market accounts are not assets and liabilities of the Province.
- The Auditor General notes that the Government has no access or discretion to use the market account assets for their own benefit, nor does the Government have an obligation to settle the market account liabilities in the event of default by market participants.

Impact of Auditor General's Qualification on IESO's Market Accounts

($ Millions)	Province's interpretation of PSAB standards	Auditor General Adjustment	Auditor General's Interpretation
Consolidated Statement of Operations			
Annual Deficit	(991)	0	(991)
Consolidated Statement of Financial Position			
Total Financial Assets	93,782	(1,652)	92,130
Total Liabilities	395,430	(1,652)	393,778
Total Debt	327,413	0	327,413
Net Debt	(301,648)	0	(301,648)
Accumulated Deficit	(193,510)	0	(193,510)

Province’s Position – Market Accounts

- Based on professional staff’s interpretation of PSAB standards, the government believes that reporting the IESO’s market accounts in the consolidated financial statements of Province is more transparent accounting.
- The IESO is a party to the contracts with each market participant, and each market participant either owes an amount to the IESO or is owed an amount from the IESO.
- The amounts due from the market participants meet the definition of an asset and the amounts due to the market participants meet the definition of a liability under PSAB standards.
- The IESO reviewed the accounting for eight other independent system operators in North America, and all but one recognize market accounts in the financial statements.
- IESO management, their Audit Committee, their Board of Directors, their external auditor and the Office of the Provincial Controller support the change in accounting.

Auditor General Opinion – Other Matters

- In the Other Matters section of the Auditor General's Opinion, the Auditor General notes:
  - IESO adopted rate-regulated accounting during the year,
  - Rate-regulated accounting is not permitted by Canadian public sector accounting standards,
  - The opinion is not modified for the use of rate-regulated accounting in 2016-17 because the adoption of rate-regulated accounting did not have a material impact on the financial statements,
  - The Ontario Fair Hydro Plan Act, 2017 and its related regulations legislate accounting, which is not in accordance with Canadian public sector accounting standards, and which may cause the financial statements to be materially misstated in the future, and
  - The Financial Statement Discussion and Analysis does not discuss pension accounting and market accounts using her interpretation of PSAB standards on these matters.

Province's use of Rate-Regulated Accounting

- The use of rate-regulated accounting by organizations controlled and included in the financial statements of the Province is not new
- Ontario Power Generation, Hydro One and Hydro One Brampton Hydro Networks Inc. all apply rate-regulated accounting in preparing their financial statements
  - These entities are included in the province's financial statements based on International Financial Reporting Standards
  - The results of these entities are included with those of the Province on a one-line basis
- Prior to its amalgamation with IESO in 2015, the Ontario Power Authority also referenced the use of rate-regulated accounting in its financial statements
  - Ontario Power Authority prepared its financial statements in accordance with Public Sector Accounting Standards
  - Ontario Power Authority was fully consolidated with the statements of the Province

Rate-Regulated Accounting Basics

- If the rates an entity is able to charge to its customers are set by another party (i.e. a regulator), provided specified criteria are met, rate-regulated accounting permits the entity to defer costs that would otherwise be expensed to the period that the related revenue is charged to customers
- Typical example:
  - A storm causes unexpected maintenance expenses of $100 million
  - The regulator (e.g. Ontario Energy Board) permits the utility to recover these costs from consumers through increased rates over five years as opposed to the year the costs are incurred by the utility
  - The utility has a rate-regulated asset of $100 million when the costs are incurred and expenses these amounts over five years (for example, $20 million per year)
  - In the absence of rate-regulated accounting, the full $100 million would be recorded as an expense in the year incurred

Rate-Regulated Accounting -- IESO

- IESO's adoption of rate-regulated accounting resulted in recognition of rate regulated assets for:
  - Unrecovered smart metering expenses -- $21.6 million
  - Unrecovered PSAB transition items related to pension and post employment benefits -- $43.4 million
- Smart metering – IESO incurred operating and capital costs related to its role as the Smart Metering Entity, which it recovers through fees from users of smart meters in Ontario, with the fees set by the Ontario Energy Board (OEB)
- Pension and post-employment benefits – IESO accounts for its pension and post-employment benefits on an accrual basis, but the OEB only permits the entity to recover for these expenses on a cash basis

Rate-Regulated Accounting and Public Sector Accounting Standards

- Public Sector Accounting Standards (PSAS) are silent on the use of rate-regulated accounting
- PSAS acknowledges that it does not provide guidance on all possible transitions and notes that it is necessary to refer to other sources of guidance:
  - *No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise. As a result, <u>matters may arise that are not specifically addressed in the primary sources of GAAP</u>. It is <u>necessary to refer to other sources when the primary sources do not deal with the accounting and reporting in financial statements of transactions or events that a public sector reporting entity encounters,</u> or when additional guidance is needed to apply a primary source to specific circumstances.*
- The following major accounting frameworks provide for the use of rate-regulated accounting:
  - International Financial Reporting Standards
  - Financial Accounting Standards Board
  - Government Accounting Standards Board
  - Accounting Standards for Private Enterprises
- IESO management, IESO's Audit Committee, IESO's Board of Directors, IESO's external auditor, and the Office of the Provincial Controller all support the use of rate-regulated accounting by IESO

Fair Hydro Plan Legislation and Related Regulations

- Ontario Fair Hydro Plan Act, 2017 (the "Act") and its related regulations establish a framework under which costs and benefits associated with Ontario's clean energy initiative are to be allocated among present and future consumers of electricity
- The Act and its related regulations enable a current reduction in electricity rates for certain classes of customers and the framework for the current reductions to be repaid in the future
- The Act and its related regulations do not prescribe the accounting to be followed by the Province
- The Province prepares its financial statements in accordance with Public Sector Accounting Standards and the transactions resulting from the enactment of the Act and its related regulations will be reported in accordance with Public Sector Accounting Standards

Appendix A – Deloitte summary of accounting opinion issued re: pension accounting

Deloitte was engaged to provide a report ("Deloitte Report") on the application of accounting standards by the Ontario Treasury Board Secretariat. Our report, which was issued on October 2, 2016, was prepared under professional standards for such reports set out by CPA Canada.

The subject of this report was the application of Public Sector Accounting Standards (PSAS), as established by CPA Canada, in the recognition of a pension asset in the Province of Ontario's financial statements. Pension accounting is subject to professional judgement and interpretation, and involves significant accounting estimates. The Deloitte Report focused on a specific aspect of this complex area as it relates to the Province of Ontario's accounting for the Ontario Teachers' Pension Plan (OTPP).

OTPP is a pension plan that is jointly sponsored by the Ontario government (or the Province) and the Ontario Teachers' Federation (OTF). Based on the Province's application of PSAS, OTPP is in a plan surplus position. We accepted this aspect of the Province's application of PSAS as a matter of fact in developing our report.

The Deloitte Report addressed the question of whether it was possible to record a pension asset related to the plan surplus in the Province's financial statements, given that the plan is jointly sponsored. We concluded that, based on the information provided to us by the Province and our professional judgement, that it was permissible under PSAS to record a pension plan asset, even though the Province's ability to benefit from any plan surplus, through future contribution reductions for example, would need to be negotiated with and agreed between the Province and OTF.

It is to be noted that even if a pension asset is recorded, PSAS would also require that consideration should be given to limiting the recorded amount of this pension asset to an amount that would be less than the calculated amount of the pension surplus. The Deloitte Report did not express a view on whether any limit to the recorded amount of the asset is needed in the case of the Province's accounting for the pension asset related to OTPP. Therefore, our report did not express a view on the amount of the pension asset that should be recorded in the Province's financial statements as at March 31, 2016 or at any other date.