TBS
Communications Branch
Your Strategic Partner

December 7, 2017

FAO's Fall Economic and Fiscal Outlook Report

Questions & Answers on TBS Related Issues

Key Messages

- The government has a strong track record of producing high-quality financial reports on a timely basis and continues to present the province's finances fairly and accurately and in accordance with Canadian Public Sector Accounting Standards.

- The government's use of external expertise for accounting and financial reporting matters supplements its own resources on complex or emerging accounting and reporting matters.

- The province will continue to prepare financial statements in accordance with Canadian Public Sector Accounting Standards that support transparency and accountability in reporting to the public, the legislature, and other users.

- The government will continue to build on its track record of responsible fiscal management.

Auditor General's Accounting Recommendations

1. **The FAO seems to have adopted the Auditor General's recommended accounting treatment for the Fair Hydro Plan and net pension assets. Why do you continue to disagree with the Auditor General?**

   The government continues to move forward and present the province's finances fairly and accurately and in accordance with Canadian Public Sector Accounting Standards (PSAS). Ontario has a strong track record of producing high-quality financial reports on a timely basis. The Auditor General's qualified opinion is based on a different interpretation of PSAS for net pension assets and recognition of market accounts.

   Last year there was a disagreement among the province's professional accounting staff and the Auditor General's Office on the appropriate application of PSAS regarding pension accounting. As a result, the Pension Asset Expert Advisory Panel was established to deliver independent advice and recommendations on the issue to the province.

The independent panel members concluded the province's share of the net pension assets of both the Ontario Teachers' Pension Plan and the Ontario Public Service Employees' Union Pension Plan should be recognized in Ontario's financial statements.

After significant deliberation, including consideration of the recommendations of the panel, Ontario confirmed that the accounting for these plans prior to 2015-16 was appropriate, and are prepared in accordance with public sector accounting standards for pension asset accounting. The 2016-17 financial statements include these pension assets, and we continue to apply the accounting treatment of pension assets that the province has used consistently since 2001. In addition, the 2015-16 financial statements were restated to include these assets.

This year the Independent Electricity System Operator (IESO) began recognizing its market accounts' assets (amounts due from power distributors) and liabilities (amounts due to power producers) in its financial results. IESO has chosen to recognize these markets accounts on its books for transparency reasons, as it better reflects the financial position of the IESO-administered markets at year-end. This change was supported by the IESO's audit committee, its independent external auditor, and finally by the Office of the Provincial Controller. This change also has no impact to the province's annual deficit, net debt or accumulated deficit.

This accounting is consistent with the presentation used previously by the Ontario Power Authority (which was merged with the IESO on January 1, 2015) in its financial statements, which was not subject to qualification from the Office of the Auditor General at that time.

Net Pension Assets Accounting

2. **Will the government follow Public Sector Accounting Standards (PSAS) for net pension assets recorded from the Ontario Teacher's Pension Plan and the Ontario Public Sector Employee's Union Pension Plan?**

The government continues to move forward and present the province's finances fairly and accurately and in accordance with Canadian Public Sector Accounting Standards (PSAS).

The Office of the Auditor General communicated its interpretation of PSAS requiring a full valuation allowance on the province's two jointly sponsored pension plans in September 2016.

At that time, the government passed a time-limited regulation on the accounting treatment of for its joint defined benefit plans to align with the Auditor General's interpretation of PSAS, which enabled officials from the Treasury Board Secretariat and the Ministry of Finance to sign the Statement of Responsibility for the 2015-16 Public Accounts.

During the 2016-17 year, the province's professional accounting staff conducted further research and analysis, and determined that PSAS does not require a valuation allowance on either of the jointly sponsored pension plans.

This conclusion is supported by:

- The conclusions reached by an independent Pension Asset Expert Advisory Panel, established by the government to provide advice on the interpretation of PSAS with respect to the reporting of net pension assets of these two joint defined benefit plans.

  The panel, comprised of accredited accounting, actuarial and legal professionals with extensive background in pension accounting and plan governance, released its report in February 2017, which supported the government's position that a valuation is not required for these two plans under PSAS.

  Two key findings of the panel were:

  1) There is no requirement under PSAS that any formal agreement exist between the joint sponsors regarding the timing or amount of a reduction in contributions to record and asset, as the existing agreements in place between the parties support the recognition of an expected benefit; and

  2) Unilateral control is not required for asset recognition. Joint control with each party having the ability to deny the actions of the other sponsor provides evidence of shared control, supporting recognition of an asset.

- An opinion from Deloitte LLP on aspects of the province's accounting as of March 31, 2016 for the Ontario Teacher's Pension Plan (OTPP). The opinion, which was dated October 2, 2016, concluded that it was permissible to recognize a pension asset under PSAS, even though the province did not have a unilateral right to reduce contributions. (The opinion did not address the value at which the asset should be recorded.)

- Analysis completed by EY as to whether any valuation allowance is required to be recorded for OTPP or Ontario Public Sector Employee's Union Pension Plan (OPSEUPP) as of March 31, 2017. EY confirmed no valuation allowance was required for either plan.

After significant deliberation, including consideration of the recommendations of the panel, Deloitte LLP and EY, Ontario confirmed that the accounting for these plans prior to 2015-16 was appropriate, and prepared in accordance with PSAS for pension asset accounting. The 2016-17 financial statements include these pension assets, and we continue to apply the accounting treatment of pension assets that the province has used consistently since 2001. In addition, the 2015-16 financial statements were restated to include these assets.

The government respectfully disagrees with the Auditor General's interpretation of the accounting standards, as PSAS neither requires unilateral control to record an asset, nor does it include a requirement to obtain a letter from the co-sponsor of the plan agreeing to reduce further contributions within 12 months.

The government is open to continue to discuss the matter in hopes of resolving this matter.

Fair Hydro Plan Accounting

3. Will the government follow Public Sector Accounting Standards (PSAS) for Ontario's Fair Hydro Plan?

The province will prepare its consolidated financial statements in accordance with Public Sector Accounting Standards (PSAS).

The proposed accounting for the Ontario Fair Hydro Plan (OFHP) reflects the economic substance of the transaction by differentiating costs borne by taxpayers versus those borne by ratepayers.

PSAS is silent on a key accounting issue regarding the OFHP – the standards neither explicitly permit, nor prohibit, the recognition, measurement, presentation, or disclosure of rate-regulated activities.

In the absence of a clear position on an issue, standard accounting practice dictates that an entity should consult other accounting standards. This guidance for PSAS is included in PS1150.07:

- *No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise. As a result, matters may arise that are not specifically addressed in the primary sources of GAAP. It is 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, or when additional guidance is needed to apply a primary source to specific circumstances. (Section PS 1150.07 from the PSA Handbook)*

The professional staff has appropriately applied this guidance in assessing the accounting for the Ontario Fair Hydro Plan.

4. Will the government follow the accounting standards set by historical precedent, as cited by the Auditor General?

The Auditor General's report makes a comparison between Ontario's Fair Hydro Plan (OFHP) and the Ontario Electricity Financial Corporation (OEFC) stranded debt. There are, however, crucial differences between the two.

For example, the OEFC stranded debt had already been incurred when the 1999 restructuring of the former Ontario Hydro took place.

In the case of OFHP, the difference between what will be collected and what will be paid to generators is considered to be an asset in accordance with the accounting definition, as it will generate a specific future revenue stream in the form of the CEA, which can be held and realized or can be sold.

It is important to note that the 1999 restructuring led to an "unbundling" of the electricity rate. Prior to the 1999 restructuring and the 2002 market opening, there was a "bundled rate" for electricity that included cost recovery of generation and transmission costs, operating and capital – including debt costs, as well as central market operations costs. Including debt cost recovery and matching the timing of the capital cost recovery with the benefit to the ratepayer is a normal rate-setting regulatory practice. It effectively amortized the cost of the investments in long-lived assets (including debt incurred).

The Debt Retirement Charge (DRC) represented the unbundling of a portion of the debt service costs. It effectively amortized the cost of the investments in long-lived assets (including debt incurred).

The OFHP Global Adjustment deferral is also intended to have costs recovered from specified ratepayers over a time period that better reflects the expected lives of those assets (versus the contract lengths that may be shorter than the expected useful life of the assets).

The difference between the 1999 restructuring and OFHP is that the DRC continued to pay down, over time, debt that had already been incurred, while under OFHP, an asset is being recorded to reflect a fair allocation of electricity costs between current and future ratepayers.

The intention of OFHP is to be forward-looking, to ensure that ratepayers are sharing current and future costs, whereas the DRC was backward-looking, replacing part of a bundled rate that was already spreading the cost recovery of the debt over time.

5. Will the government implement the recommendations in the Auditor General's Special Report on the Fair Hydro Plan?

While the government does not agree with the assertions and conclusions expressed in the report, the government thanks the Office of the Auditor General for its report.

In developing Ontario's Fair Hydro Plan (OFHP), the government considered a range of implementation options and consulted with legal, accounting, financial and energy sector third-party experts to provide advice and ensure due diligence was completed.

OFHP operates under a financial and accounting framework that is appropriate for the intended purpose. It is in accordance with Public Sector Accounting Standards (PSAS) and ensures the goals underlying the program are achieved in a cost-effective manner.

On the point of "true financial impact":

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.

The province's financial statements are prepared in accordance with Canadian PSAS and will follow PSAS in accounting for the transactions resulting from OFHP in 2017-18, and in following years.

As PSAS is set by an independent standard-setting body in Canada focused specifically on the public sector, and because PSAS is used by all senior governments in Canada, presenting financial statements in accordance with PSAS results in transparent financial reporting for the Province of Ontario.

Ontario has a strong track record of producing high-quality financial reports on a timely basis, and will continue to move forward and present the province's finances fairly, accurately and in accordance with PSAS.

On the point of "a financing structure that is the least costly for Ontarians":

The OFHP financing structure has been designed to provide electricity rate relief to current ratepayers, including by more fairly allocating costs for specified consumers, with the Global Adjustment cost amounts still ultimately borne by specified electricity ratepayers, as beneficiaries of those electricity system costs.

The government believes it is appropriate for ratepayers to pay for the financing of electricity assets. Having the rate-base pay is not a new policy, for example Hydro One has borrowed in the capital markets since 2000.

Ontario Power Generation (OPG) was identified as the Financial Services Manager responsible for the financing plans and the financing entity (the Fair Hydro Plan Trust) that will manage the debt obligations. OPG is beginning the process of raising funds to finance the deferred costs, and while total borrowing costs will not be known until the program is complete, accumulated interest is projected to be considerably less than the estimates in the May 2017 report of the Financial Accountability Office (FAO).

The cost analysis in the Office of the Auditor General's report was sourced from the FAO's May 2017 report. Total borrowing estimates over the thirty year life of OFHP have been revised down substantially by the government since the FAO released its report in May 2017, and borrowing costs are now forecast to be substantially lower than original estimates. Recent government estimates forecast that the peak debt over the thirty year life of OFHP will be below $20 billion. The preliminary estimate from March 2017 was about $28 billion.

The province will continue to prepare its consolidated financial statements in accordance with PSAS and continue to build on a track record of responsible fiscal management.

6. **The Auditor General says that she has consulted with all of the Auditor Generals in Canada – and they agree with her assessments. How are we supposed to believe this government when all legislative auditors in the country say you are wrong?**

   In developing Ontario's Fair Hydro Plan, the government considered a range of implementation options and consulted with legal, accounting, financial and energy sector third-party experts to provide advice and ensure due diligence was completed.

   PSAS is principle based – the standards are not a set of specific prescriptive rules. Applying them requires the application of professional judgment.

   Our professional staff exercises judgment in applying the standards and as necessary consult with external experts and advisors. They provide the Office of the Auditor General with their written analysis on all significant issues that impact the financial statements for the year being audited, and they discuss the issues with the Office of the Auditor General.

All Chartered Professional Accountants (CPAs), including those employed by the Ontario Public Service (OPS), are required to comply with the Code of Professional Conduct for CPAs. One of those rules is that they not be associated with false or misleading information.

That means that if the professional accountants in the OPS do not agree with the judgment of the Ontario Auditor General, it is not as simple as just agreeing to accept the interpretation of the Office of the Auditor General if they believe that interpretation would result in false or misleading financial statements. While we expect professional accountants to agree on the vast majority of issues, we acknowledge that they may not agree on everything and when that occurs, and the difference is material to the financial statements, the Office of the Auditor.

7. Are you concerned that the Auditor General will issue an adverse opinion on the province's next Public Accounts due to Ontario's Fair Hydro Plan accounting? What would be the impact on the province's credit rating?

It would be inappropriate to speculate about how the Auditor General may issue an opinion for Public Accounts next year. The implementation of Ontario's Fair Hydro Plan (OFHP) is ongoing, with significant decisions with accounting and financial implications still being finalized.

The Ministries of Energy and Finance, and the Treasury Board Secretariat continue to work closely with Ontario Power Generation (OPG), the Independent Electricity System Operator (IESO), as well as third-party experts to ensure appropriate due diligence is completed.

The province's financial statements are prepared in accordance with Canadian PSAS and will follow PSAS in accounting for the transactions resulting from OFHP in 2017-18, and in following years.

The financing plan for OFHP and its impact will be transparent. Credit rating agencies, securities regulators, and the public will see full information and full reporting of the impacts of OFHP.

Ontario has a strong track record of producing high-quality financial reports on a timely basis. Ontario will continue to move forward and present the province's finances fairly and accurately and in accordance with PSAS.

Province's Debt Burden

8. **Will the government develop a long-term total-debt reduction plan linked to its target of reducing debt-to-GDP ratio to its pre-recession level of 27 per cent? Will you be making this plan public?**

   The 2017 Budget and the 2017 Fall Economic Statement stated that the government continues to maintain a target of reducing the net debt-to-GDP ratio to its pre-recession level of 27 per cent, currently projected for 2029-30, together with an interim target of 35% by 2023-24.

   From 2017-18 onwards, the balanced budget environment will limit increases in debt to the difference between annual investments in infrastructure improvements and the amortization of such investments.

   The government's long-term infrastructure plan to invest about $190 billion over 13 years, starting in 2014-15, will contribute to the growth of the economy. The Centre for Spatial Economics found that for every $1 spent on public infrastructure, GDP increases by up to $6, on average, in the long term.

   Therefore, while overall debt will rise to fund these infrastructure investments, measurements of relative debt such as the net debt-to-GDP ratio, a recommended indicator by the Public Sector Accounting Board, will gradually diminish due to the province's GDP increasing at a faster rate than net debt.

   This will allow the government to continue to move towards its 27 per cent net debt-to-GDP target. The ratio has already commenced declining, falling to 37.3 per cent in 2017-18 from its 2014-15 peak of 39.3 per cent.

9. **How can your debt reduction plan be trusted if you're not using proper accounting for pension assets and the Fair Hydro Plan?**

   The province is committed to providing high-quality financial reports that support transparency and accountability in reporting to the public, the legislature, and other users.

   The province's financial statements are prepared in accordance with Canadian Public Sector Accounting Standards (PSAS), including the net pension assets for its jointly sponsored pension plans and the transactions resulting from the Ontario Fair Hydro Plan.

   PSAS is set by an independent standard-setting body in Canada focused specifically on the public sector, and is used by all senior governments in Canada.

PSAS is principle based – the standards are not a set of specific prescriptive rules. Applying them requires the application of professional judgment.

Our professional staff exercises judgment in applying the standards and as necessary consults with external experts and advisors. They provide the Office of the Auditor General with their written analysis on all significant issues that impact the financial statements for the year being audited, and they discuss the issues with the Office of the Auditor General.

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