Office of the Auditor General of Ontario
Bureau de la vérificatrice générale de l'Ontario

Remarks by Auditor General Bonnie Lysyk to The Standing Committee on Justice Policy on Bill 132 *Ontario Fair Hydro Plan Act, 2017*

May 24 ,2017

Good morning. I'm Bonnie Lysyk and I'm the Auditor General of Ontario. Thank you for letting me comment on Bill 132.

It is not the job of the Auditor General to comment on government policy. The government's decision to borrow money to lower hydro bills by 25% is a policy decision, and so I have no comment on it. However, when it comes to the accounting for such a decision, it is my responsibility to make sure that it is properly recorded in the consolidated financial statements of the Province and is transparently reported to the people of Ontario. And this is why I am here today.

TBS: *We share the AG's objective of ensuring that the economic substance of the government's activities are fairly and transparently reflected in the government's books. We agree that the government's proposal is complex and we welcome an opportunity to clarify our position on the substance of the various elements which appears to differ from the AG's interpretation (based on the Auditor's remarks made last week).*

The accounting transaction is structured in a complex manner. In simple terms, the government plans to record as an asset the expected recovery of the 25% in electricity costs from future ratepayers that it will borrow for and pay to power producers today. In essence, it is setting up as an asset an accounts receivable that it expects to collect from future ratepayers between 2022 and 2047 that is not yet an accounts receivable because the consumer has not yet used the electricity.

TBS: *The AG makes several references that don't reflect the actual substance of the transaction:*

- *In the past, the GA costs recovered by the IESO reflected a 'right' to recover which was established legislation. Recovery as provided for through legislation is also consistent with some of OPG's costs. Through the FHP, the proposed legislation would merely defer a portion of the otherwise recoverable amount for a period of time, but would not otherwise change the nature of the 'right' to recover the amount from ratepayers.*
- *The recovery from the ratepayers is not 25% -- the 8% rebate is not recoverable and the impact of moving the social programs from the rate base to the tax base is not recoverable from the future ratepayers*
- *The AG's reference to the deferrals representing an 'expected recovery' from future ratepayers that is an AR related to electricity not yet consumed is confusing and misleading with regards to the substance of the intended accounting. The costs already incurred and recoverable under legislation – they are being deferred. Revenue is not being recorded in advance of it being earned.*

It would be helpful if the AG could explain her remarks w.r.t. the receivable (rate regulated asset) ***relating to future electricity not yet consumed****. The RRA will be recovered from future ratepayers, but is related to past costs incurred. The recovery of RRA through future rates is a basic concept under rate regulated accounting.*
The AG's suggestion that the government is using ***'legislated accounting'*** *or 'legislation to create an asset' is not accurate. While the recovery of the deferred costs will be provided for through legislation, similar to some of OPG's costs, the FHP does NOT involve legislated accounting by IESO, OPG or the Province. The AG should be asked to clarify her remarks.*

- ***Management of IESO is responsible for the fair reporting of IESO's transactions*** *and the government supports their efforts to ensure that the economic substance of their activities are presented (both in relation to past results for which the IESO has recently adopted Rate Regulated accounting, as well as future accounting under the FHP).*

A similar move to legislate accounting to defer costs was proposed with the restructuring of the Ontario electricity sector in the late 1990s. At that time, the government did not want the net impact of the stranded debt, which had already been incurred, to be reflected on the Province's financial statements. Because it anticipated that ratepayers would pay down this debt, it wanted to create an asset to reflect those future anticipated revenues from electricity ratepayers. This approach would have fully offset the total stranded debt, such that there would have been no net debt impact reflected on the Province's consolidated financial statements. The Auditor General's opinion, as stated in our Office's 2000 Annual Report, was that this [quote] "would have set an unacceptable precedent for government accounting. It would also have represented a departure from one of the central tenets of generally accepted accounting principles—that revenue not be recognized until it is earned." [end quote] The government heard these concerns and was prudent in making the decision to not create an asset for future anticipated ratepayer payments. I believe those concerns are equally applicable today.

TBS:
The appropriate accounting for the FHP is being assessed based on current accounting standards, and should not necessarily be compared to decisions made decades ago. An analysis of the differences between the fair hydro plan and the debt retirement charge is being prepared and will be shared with your office.

The government of today plans to borrow about $26 billion to cover the 25% shortfall from ratepayers, but it does not want to reflect the overall impact of these borrowings on the consolidated financial statements of the Province, which includes the electricity sector. It plans to record anticipated revenue as an asset to offset borrowings in its consolidated financial statements. As a result, there will be no impact on net debt on the Province's balance sheet. As well, this legislation is designed so that there will be no impact on the Province's calculation of the annual surplus or deficit. Today, like in 2000, we believe this sets a dangerous precedent.

Let me give you an example. Snow plowing in Ontario is performed by private-sector contractors who own equipment. The contractors' bills are properly included as a government expense each year. Now, say the government decides that taxpayers are paying too much for snow plowing and points out that there is value in the snow plowing equipment beyond the term of the contracts. It could argue that it expects to negotiate significantly lower rates in future contracts and wants to defer some current snow plowing costs into the future to "smooth" these costs over time. For obvious reasons, this is not allowed under Canadian public-sector accounting standards. As we know, accounting deals with past transactions, not future ones. So to anticipate that private-sector electricity generators will reduce their costs in the future and to use legislation to make this potential future benefit an asset is also not allowed under Canadian public-sector accounting standards.

> TBS:
> *The proposed accounting does not reflect assumptions regarding future GA costs, or contract negotiations with electricity suppliers; rather, it reflects a deferred amount that will be legally recoverable through future rates.*

So what's the bottom line? I would not be doing my job as Auditor General if I said that creating assets through legislation is acceptable. Under this Bill, the government's policy decision to borrow money to subsidize electricity bills will not affect the Province's net debt or annual deficit. This legislated accounting is not in accordance with Canadian public-sector accounting standards. These standards are there to ensure that the financial reporting of government policy decisions reflects common sense: borrowings are debt; **unearned revenue** is not an asset today; and when your expenses exceed your revenues, you incur a deficit. Such common sense and the principle of substance over form should prevail in the financial reporting of government policy decisions.

> TBS:
> *References to 'legislated accounting' and 'unearned revenue' are not appropriate in the context of the FHP. The government is not legislating accounting, but rather enabling the deferral of currently recoverable (and future recoverable) costs through legislation. Since the IESO is a rate regulated entity, it has determined that the appropriate accounting would be to reflect a rate regulated asset on its books to reflect the deferred charges. It is not unearned revenue. In fact, unearned revenue would be reflected as a credit on the entity's books. Rather, it is a deferred asset that represents COSTS ALREADY INCURRED that will be recovered through future rates. The nature of these deferred charges are not different that OPG's rate regulated assets established through legislation and reported on the government's books.*

I now welcome any questions you might have.

QUESTIONS:

Delaney: Good Morning Auditor, nice to see you again, the Ontario Energy Board and the independent electricity system operator practiced the policy of deferral accounts fairly frequently, could you comment on that?

Lysyk:

- With respect to this legislation, the government is legislating the behaviour and activities of the Ontario Energy Board with respect to this transaction
- We do not view them independent
- The power contracts that were negotiated
- That were government policy decision are not regulatory assets
- Because they were never fielded before regulator in Canada

Delaney: Okay, in your opinion, would you give me a comment on the practice of spreading the costs of necessary infrastructure investments in general electricity, infrastructure in particular, in a way that more accurately represents the useful lifespan of those assets, given that the lifetime of those assets over the decades has expanded?

Lysyk

- So in the case of the contracts that we're talking about
- The government does not own the assets
- They are owned by third parties
- And therefore the spreading of third party costs is a very unusual treatment
- And wouldn't have benefit to electricity ratepayers
- Because they have no assets to generate the power they need to pay for in the future
- Because the government does not own those assets

Delaney: Okay, did your remarks in your presentation this morning accurately describe, in your opinion, what a regulatory asset is?

Lysyk:

- Under PSA, Public Sector Accounting Standards, regulatory assets are considered intangibles
- And cannot be booked on financial statements in Canada
- US GAAP might allow it
- But US GAAP is not acceptable presentation standards for the government's financial statement

Delaney: Okay, Thank you very much
Chair Vernile: Our next questions for you are from MPP Walker
Walker: Good Morning, how are you?
Lysyk

- Good Morning

Walker: This morning in the Fiscal Accountability Officer's document that he shared with us, he has a number 4 – it's actually titled accounting treatment uncertainty. It says, due to the nature of the proposed financing transaction, the FAO recommends that members of provincial parliament obtain assurance from the office of the Auditor General of Ontario, that the province has proposed accounting treatment for the electricity cost refinancing meets public sector accounting standards, and will not impact the province's annual surplus deficit – the net debt, Can you just make a quick comment on that, because I have a number of other questions

Commented [OPCD1]: Same as for certain of OPG's costs which are reflected as rate regulated assets under US GAAP and IFRS14 (also based on US GAAP)

Commented [OPCD2]: Accounting standards do not require the Regulator to be independent (neither US GAAP nor current IASB deliberations on RRA)

Commented [OPCD3]: 2 types of regulator assets – both reported by Canadian rate regulated entities, including OPG

Commented [OPCD4]: FHP is 'reprofiling' collection of costs already incurred which is creating the deferred charge (rate regulated asset). The Navigant Report will provide additional support for the government's policy, but is not relevant for purposes of assessing appropriate accounting treatment under PSAS (IESO/ON) or IFRS14 (OPG).

Commented [OPCD5]: Inaccurate and misleading. PSAS does not even address RRA. The closest PSAS comes to addressing RRA is the Year 2000 study which supported reporting of RRA by both public sector and private sector entities.

Commented [OPCD6]: This is inaccurate and misleading. All rate regulated entities in Canada which report RR Assets are doing so based on USGAAP, whether they report based on US Accounting Standards or on IFRS (Under IFRS14).

Lysyk

· Yeah
· I would say at this point in time that based on the information that has been presented in the bill, and based on some of our own initiative – initiated work
· The transaction as proposed is legislated accounting
· And does not meet public sector accounting standards

*Walker: Agreed. And I think – you know – some of the comments you made, it sets a dangerous precedent, it's already been looked at to do this one other time, the government of the day actually prevailed and said you're right, we accept that, so it's interesting that the shell game is back on the docket, I think what you said at the very end of your document, borrowings are debt, unearned revenue is not an asset today, and when your expenses exceed your revenues, you incur a deficit. At the end of the day, what I can't seem to find *inaudible* explain how the government *inaudible* they're borrowing money *inaudible* pay their, their payment plan. And it's adding money. The figures this morning went as high as 93 billion dollars this could cost the taxpayers of Ontario. So I don't care whether you call me a taxpayer, a ratepayer, you call me whatever you want. But at the end of the day, the people of Ontario are going to have to pay this debt back. Is that true?*

Lysyk:

· That is true
· The financial statements for the government include the electricity sector, similar to the transaction for the Debt Retirement Fund—OEFC tracked the difference between the rate regulator and the government
· And so that worked well
· In that case, the debt was recorded on the province's statement
· At the end of the day what this is a financing transaction
· It is the government borrowing—needing to borrow money—to cover the difference between what they're collecting from ratepayers and what they're paying to the power producers
· That's pretty much the simplicity of it

Walker: and, and they're putting it on OPG's books, so it won't show as a net deficit or impact them in a negative consequence on their actual books.

Lysyk:

· That's correct
· All the transactions are designed not to affect net debt on the province's books and not to affect the bottom line annual deficit or surplus of the government

Walker: and if these unearned revenues that they're assuming don't come through, who's on the hook to pay those. Regardless of whether they're on OPG's books or they're on the government books?

Lysyk:

· It would still be the province

Walker: the province—the people of the Province of Ontario, is that correct?

Lysyk:

· Correct

Walker: because that's where the money comes—the province has no money, it comes from the people.

Commented [OPCD7]: The Province is not legislating accounting, but rather a rate regulated asset is being created through legislation and it will be treated in accordance with GAAP as such.

Commented [OPCD8]: The deferred charges will be recovered from future RATEPAYERS, and under rate regulated accounting, such deferred charges (incurred costs which will be recovered through future rates) are to be reported as rate regulated assets. To record them otherwise would be misleading. IESO accounting for Smart Meter costs, for example, was having a misleading impact on the entity's financial performance.

Commented [OPCD9]: Through legislation, the IESO would retain the right to recover the costs, but through a longer period than currently (within 12 months).

Commented [OPCD10]: Confusing statement for the public. There is no expectation at this point that these costs would be recovered from the tax base.

Lysyk:

- Correct, I think—

Walker: yes.

Lysyk:

- --there are a lot of people investing a lot of time and money to set this up, structure it in such a way that it doesn't affect the bottom line

Walker: is it a fair statement—even if they were to borrow this 26 billion dollars—if they borrow it as the Province of Ontario, the rate to actually borrow would be much less than it will be by putting, say, 55 percent on OPG's books. OPG cannot borrow at the same rate as the Province of Ontario?

Lysyk:

- I believe so but I, I'm not the authority on the—

Chair Vernile: thank you very much, Mr. Walker.

Walker: we were told that it was about a 4-billion dollar—

Chair Vernile: and our final questions for you today are from Mr. Tabuns.

Tabuns: thank you, Chair. Ms. Lysyk, thank you very much for appearing today. You've said to us then that what's proposed by the government does not accept public sector accounting standards. If a statement was brought to you that did not include these funds—say a statement of income and expense for the province as a whole. If a balance sheet came forward and didn't include this, would you be able to rule that that was an acceptable presentation of the province's liabilities and assets?

Lysyk:

- If the transaction was put through the government's statements like the legislation is proposing, that would put me in a position where I would need to qualify on the government's financial statements

Tabuns: well, that's a pretty straightforward response. If this was put on the government's books and we didn't have this shell entity set up under OPG, this, this borrowing—these expenditures—would they be affecting the annually-stated surplus and deficit of the province?

Lysyk:

- That's correct
- Every year the difference between what's paid to the power generators and what's collected from consumers would hit the bottom line of the government as a [sic] impact on the accumulated—on the deficit or surplus
- And as well as, there would be the debt on the province's books and the interest from that debt

Tabuns: and so—

Lysyk:

- This—

Tabuns: --it would increase the province's total debt. It wouldn't be set aside. The, the legislation, as written, seems to be an attempt to move all of this off the books. But that is not something that you would accept as an auditor?

Lysyk:
- The net debt number is an important number that we think needs to be fairly presented
- As well—legislative accounting is a risky thing
- Legislative accounting sets the tone for any government to decide what the accounting for a transaction should be, even if it's contrary to public sector accounting standards
- And so this is a sensitive issue, not just for my office, but for Auditor Generals' offices across Canada

Commented [OPCD11]: Inaccurate. Government is not legislating accounting.

Tabuns: and how would—

Lysyk:
- This is precedent-setting

Tabuns: --I have no doubt that this is precedent-setting. It's—I, I, I've found from the beginning this idea of setting up a, a shell company under OPG was an extraordinary measure. How would bond-rating agencies respond to this misstatement of the province's actual revenue and expenses?

Lysyk:
- I, you know, I think at the end of the day, people—if they look at the consolidated financial statements—recognize that the source of money is one person, a person in Ontario
- And so whether it's the ratepayer or a taxpayer, it's captured in the statements
- You can still keep track of the difference between ratepayers and, and taxpayers
- So I think, you know, the—I would assume the bond-rating agencies are smart enough to understand that at the end of the day, if there was risk, it would be picked up by the province

Tabuns: so would you urge the government to actually follow standard public-sector accounting principles?

Lysyk:
- We would recommend that the government reconsider this bill—

Commented [OPCD12]: Policy?